REVENUE ACT OF 1942

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

SEVENTY-SEVENTH CONGRESS

SECOND SESSION

ON

H. R. 7378

AN ACT TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

REVISED

JULY 23, 24, 27, 28, 29, 30, 31, AUGUST 3, 4, 5, 6, and 7, 1942

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REVENUE ACT OF 1942

THURSDAY, JULY 23, 1942

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

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

The CHAIRMAN. The committee will please come to order. The committee has before it the 1942 revenue bill, H. R. 7378. The Secretary of the Treasury is here this morning. Mr. Secretary, we will be pleased to hear from you first, and all questions will be deferred until you have finished your statement, if that is agreeable to you.

STATEMENT OF HON. HENRY MORGENTHAU, JR., SECRETARY OF THE TREASURY, WASHINGTON, D. C. (ACCOMPANIED BY DANIEL W. BELL, UNDER SECRETARY OF THE TREASURY, AND RANDOLPH E. PAUL, SPECIAL TAX ADVISER TO THE SECRETARY OF THE TREASURY)

Secretary MORGENTHAU. Mr. Chairman, and members of the committee: You will recall that in his Budget message of January 5, President Roosevelt asked for additional taxes for the fiscal year 1943, exclusive of social security taxes, of $7,000,000,000. On March 3, I appeared before the Committee on Ways and Means of the House and presented recommendations for a tax program to produce $7,600,000,000 in additional annual revenue from taxes. On May 6, I wrote a letter to the chairman of the Committee on Ways and Means recommending a reduction in personal income-tax exemption to produce approximately $1,100,000,000 more revenue. These two recommendations together involved a tax program of $8,700,000,000 of additional revenue. These amounts represented what I believed, and still believe, was the very least that the American people could afford to provide.

It is only against the background of our war expenditures that we can tell whether the revenue bill before you will fulfill its purpose. We are now spending $150,000,000 a day or almost $5,000,000,000 a month. In the fiscal year that is beginning we expect to spend the almost inconceivable sum of $77,000,000,000 to win this war for human freedom.

There can be no compromise with these war expenditures. We would not reduce them if we could. Our whole effort must be to trans-

late our spending as fast and as effectively as possible in the actual production and use of our war materials. If our expenditures this year reach $77,000,000,000, our receipts in revenue from the people must bear some reasonable relationship to that colossal figure. If the House bill were to become law it would be necessary to borrow from the public during this fiscal year about $53,000,000,000. To the extent that we enlist our current income in taxes to cut down this borrowing, we shall be protecting the future economic soundness of our country and our free institutions. To the extent that we fail, we shall be endangering the survival of all that we are fighting to preserve.

It is interesting to remember that only 2 years ago, in the fiscal year 1941, we were devoting only about 7 percent of our national income to defense expenditures. In the present fiscal year we shall be spending about half of our national income on the war. Thanks to the foresight of President Roosevelt and the splendid cooperation of Congress, we expect to devote to the war effort in our first complete fiscal year of war a proportion of our national income roughly comparable to the proportion being spent by Canada and approaching that being spent in Great Britain.

We get a different picture, however, if we look at the percent of expenditures financed through taxes in the three countries. In the fiscal year 1941 Canada financed about 70 percent of all its expenditures by taxation and in the fiscal year 1943 it expects to raise about 55 percent from taxes.

The United Kingdom, in the fiscal year 1941, financed 44 percent of all its expenditures by taxation, and in the fiscal year 1943 it expects to raise 53 percent from taxes. In the United States, however, including Federal, State and local governments, only 37 percent of all fiscal 1943 Government expenditures would be financed by taxation on the basis of the revenue bill now before you. It is clear that we are substantially behind Great Britain and Canada in the proportion of our expenditures which we are raising from taxes. Quite frankly, I do not see why we should not do at least as well as Great Britain and Canada.

TAXATION AND THE COST OF LIVING

Taxation does more than supply money to finance the war. It does more than apportion the war burden now, once and for all, instead of leaving it for further distribution through taxes after the war. Wartime taxation also plays an important part in preventing rapid and continued increases in the cost of living. The President has announced a 7-point program for holding down the cost of living. Ceilings have been placed on prices. This fact may have caused many people to be unduly optimistic about the future of the cost of living. It cannot be too strongly emphasized that if the price ceilings are to be maintained and rapid and continuous price rises avoided, the pressure of the large and expanding volume of consumer purchasing power on the diminishing supply of goods must be reduced.

To reach a much larger volume of consumer purchasing power, the bill now before you includes such a broad reduction of personal exemptions that it will affect almost seven million individuals who have never paid direct taxes to the Federal Government before. If this section of the bill is passed as it stands, some thirty-one million income-

tax returns will be filed in 1943, as against only 7,700,000 in 1940. For the first time in our history the income tax is becoming a people's tax.

Taxes cannot, by themselves, win the battle against inflation. The battle must be fought with determined and coordinated effort on many fronts. Taxation can be fully effective in this battle only if it is accompanied by restraint and self-denial in other fields. Nevertheless, taxation by itself can make the price situation more controllable and less dangerous than it otherwise would be, and it is an essential anti-inflationary weapon that must be used to the utmost. Inflation has been well described as "the ruthless process whereby sacrifice is imposed inequitably upon a people who have lacked the unity, the courage and intelligence to impose that sacrifice equitably upon themselves." It is for us to show that we have the unity, the courage and the intelligence to check inflation now.

TREASURY PROGRAM A MINIMUM PROGRAM

The administration's revenue program was presented last spring as a minimum. On March 3, when I first came before the Ways and Means Committee, our total contemplated expenditures for the fiscal year 1943 were $63,000,000,000. Since then they have risen by $14,000,000,000, and the total war appropriations, authorizations and requests for this and succeeding fiscal years have risen by $75,000,000,000. It is true that the bill before you would produce by far the greatest revenues in our history, and I would not wish for one moment to minimize the task performed by the Ways and Means Committee. Yet this bill would provide only $6,300,000,000 additional revenue in place of the $8,700,000,000 we recommended in the spring. It would fail by about $2,400,000,000 to reach that minimum of last spring, which is even more emphatically the very least we can afford to provide today.

In presenting its revenue program to the Committee on Ways and Means, the Treasury outlined methods of taxation which it considered most desirable and appropriate to raise the required amounts. I still believe that these proposals are sound and present the best sources for a revenue program of this size. They are based upon the principle of ability to pay, and they avoid such devices as a general sales tax, which would fall with the greatest impact upon those least able to bear the burden. The various provisions of the administration program are well known and it is not necessary to repeat them here. I should like, however, to emphasize certain points which I hope will be most carefully considered by the committee.

1. *Special privileges.*—The revenue bill as it stands violates the basic principle of equity which is so important to an all-out war finance program. It does this by leaving certain highly privileged groups free from tax on large portions of their income.

The first of these especially favored groups are the recipients of tax-free interest from State and municipal securities. Exemption of interest on State and local securities is a serious breach in our system of taxing according to ability to pay. For example, in the case of one individual, out of a total reported income of approximately $975,000, over $668,000 came from State and local securities. If the bill as it passed the House should become law, this individual would pay only $243,000; if, on the other hand, your committee would adopt

my suggestion and remove this pre-Pearl Harbor exemption, he would pay $832,000.

Senator BARKLEY. Let me ask you, Mr. Secretary, you emphasize pre-Pearl Harbor exemption. That was pre-World War No. 1 exemption as well as pre-Pearl Harbor, was it not?

Secretary MORGENTHAU. That is true.

Senator BARKLEY. In other words, this exemption privilege has been one that has existed ever since the local securities were issued. I think it is not quite fair to say that this exemption was a pre-Pearl Harbor exemption. While that is true, all right, it has been an exemption for years and years.

Senator VANDENBERG. It even has something to do with the Constitution, does it not?

Senator BARKLEY. I do not know about that. There is a constitutional question involved, but I do not want to go into that.

Senator VANDENBERG. That is very far back.

Senator BARKLEY. I doubt the wisdom of undertaking to create the impression that this exemption which existed for a generation is just limited to a pre-Pearl Harbor exemption. I do not see just what Pearl Harbor has to do with it.

Secretary MORGENTHAU. Well, Pearl Harbor, Senator Barkley, I need not remind you, happened to be the date when we were attacked.

Senator BARKLEY. Yes; I am familiar with that date. But the point is that this is a matter that ought to be considered on its merits and not on account of any particular date, it seems to me. I do not quite see the relevancy of using Pearl Harbor as a date when this legal exemption and privilege has existed from time immemorial, ever since these securities were issued. I am not passing on the merits of the question of their taxation.

Secretary MORGENTHAU. To answer your question or your criticism, I happen to believe that beginning with Pearl Harbor on December 7, and facing what we do, we have to change our entire mode of living. I just do not believe that the people should enjoy these special privileges that they had prior to December 7 while we are calling on the people of this country to make the sacrifices which they are going to have to make to win this war. I believe that these few people should be asked to give up these special privileges.

Senator BARKLEY. That is a question that goes to the merits of the proposition, but the point that seems to me to be impotrant involves the legality of undertaking to tax exempt securities that have been exempt under our Constitution and laws from time immemorial, since they were issued.

It involves securities upon which the rate of interest was fixed according to the exemption, and a lot of questions enter into that which bother me. I am not attempting in any way now by my question, Mr. Secretary, to foreclose the question, or to preclude myself from considering it on its merits when we get to it, but I just frankly cannot quite comprehend the necessity of using any particular date. We have all got to make more sacrifices, and we are making more and we have to make still more now than anybody contemplates, but we have also got to keep in mind the question of law, the question of the Constitution and the right of Congress to deal with subjects which have been fixed in our law and in the

Constitution of the United States for a long, long time, and I would not want to vote to violate the law and the Constitution of this country in order to make somebody sacrifice more than he would sacrifice if he complied with the law and the Constitution.

Secretary MORGENTHAU. Senator Barkley, any time that you, or the chairman, or any other member of the committee wishes, we are prepared to give the legal interpretation as to why we think that this is possible and proper and ethical.

Senator VANDENBERG. The legality did not change beyond December 7.

Secretary MORGENTHAU. No.

Senator VANDENBERG. That is the point Senator Barkley made.

Secretary MORGENTHAU. As I say, when you get into the legal question, the Treasury's attorneys are prepared to argue that point.

May I continue?

The CHAIRMAN. Yes.

Senator BARKLEY. I beg your pardon for interrupting.

Secretary MORGENTHAU. That is all right.

Senator BARKLEY. That thing kind of stuck in my craw there.

Secretary MORGENTHAU. If you do not mind my saying so, Pearl Harbor kind of sticks in my craw, too.

Senator BARKLEY. I think both of our craws have been affected very largely by Pearl Harbor.

Secretary MORGENTHAU. May I continue?

The CHAIRMAN. Yes, sir. You may continue.

Secretary MORGENTHAU. All right.

Let me put the illustration another way. If this exemption is retained, he would have $732,000 left after taxes; if it is abolished, he would have $143,000 left.

The glaring unfairness of this exemption may be seen in another way.

Under the tax rates in the House bill, a person with a surtax income of $100,000 from other sources who holds a 3-percent tax exempt security receives as much net return after taxes as from a taxable security yielding 20 percent. The existence of this special privilege for all holders of tax-free securities costs the Government and the people of the United States, under the House rates of tax, about $200,000,000 a year; and it will cost still more as our wartime taxes tempt more and more wealthy individuals to shift their investments into the hide-out of tax-exempt securities.

How can we expect to obtain an all-out war effort from all our people if we go on permitting a group of individuals and corporations owning $14,000,000,000 of State and local securities to go tax free on the income from these securities. We are asking our young men to give their lives for their country, and at the same time we are allowing many wealthy persons, safe behind the lines, to escape their fair share of the war's financial burden. At a time when we are straining our energies to the utmost to defeat a powerful and ruthless foe, common decency requires that we abolish these special tax shelters, and do it now.

Another highly privileged group having large amounts of income exempt from income tax are the owners of oil wells and mines. I refer to those provisions of the law dealing with percentage deple-

tion. Percentage depletion is a serious breach in our system of taxation according to ability to pay.

I cannot believe that the taxpayers of America would knowingly sanction a provision of the law which allows owners of oil and gas wells to deduct from their income 27½ percent of their gross receipts from such wells—not for 1 year, 2 years, or the period necessary to return investment, but for an unlimited period. For example, a leading oil company owned a number of oil properties which had cost it $3,000,000. At the time the case was examined, percentage depletion of $3,600,000 had already been allowed and the properties still had three-fourths of the oil left.

Certainly we cannot justify this exemption on the ground that it encourages exploration and drilling for oil. There is grave doubt that it has a substantial effect on oil discovery. It would have cost the Federal Government about one-third as much to have paid all the cost of every wildcat well that was drilled in 1941 as to have allowed percentage depletion and the associated intangible drilling expenses. The annual cost of these allowances under the proposed rates would be about $200,000,000.

The privilege of filing separate income-tax returns furnishes another example of special tax advantages to many married couples having larger than ordinary incomes. In families in which the income is earned partly by the husband and partly by the wife and in families in which income-earning property can be divided between husband and wife, the tax on the family income is less than where the husband or wife receives the whole income. The family is the true economic unit, and it is unfair for the amount of tax on the family to vary depending upon who earns the income or upon who in the family has income-producing property. Ability to pay taxes must be judged in terms of family incomes and not the incomes of members of the family. The failure to require joint-income-tax returns constitutes a violation of the fundamental principle upon which our tax system has been based.

The adoption of mandatory joint returns would also eliminate another discrimination prevailing under existing law. Married couples living in the eight so-called community-property States receive tax advantages which are in no way commensurate with any special relationship that may exist between husbands and wives in those States. For example, take a family in which the husband has a salary of $10,000 after deductions. If the family has its residence in, say, California, and files community-property returns, the family tax would be $1,788, while if the family lives in, say, Iowa, the tax would be $2,152 or over 20 percent more. The discrimination is even more pronounced with larger incomes. In this national emergency, how can we complacently permit the citizens of these community-property States a more favorable tax status than those of the rest of the country?

These examples of special privileges are intolerable at a time like this, when we are imposing heavy taxes on persons with small incomes and there is pressure for limiting wages and farm prices. The country is in greater danger today than ever before in its history. The war is now in its most critical phase, and only by pulling together as a united people can we make the effort that will turn the tide toward victory. At such a time any special privilege for any

group not only deprives the Treasury of revenue that is badly needed for the war effort, but hinders the war effort by undermining the morale without which the war cannot be won.

2. *Excess-profits tax.*—Another similar hindrance to the prosecution of this "people's war" is the existence of excessive profits in wartime. There is no easier way to stir the righteous anger of the American people than to let them hear constantly of excessive wartime profits that are not being recovered by adequate taxation. I have said repeatedly that we are determined to take the profit out of war, and the Treasury's recommendations have been framed with this determination in mind.

An effective excess-profits tax does much more than produce badly needed revenue in time of war. It also reassures the masses of our farmers and factory workers that industry is not being rewarded unduly for its part in the winning of the war.

I do not believe that any patriotic American needs the "incentive" of profits to produce for war at this time. Millions of our people are willing to pay new and genuinely burdensome taxes, to buy war bonds without stint, and to do without many of the accustomed luxuries and even conveniences of daily life. Their only "incentive" is their firm resolve to win this war and build a better future.

Experience has shown, however, that when excess-profits taxes are too high they may result in extravagance and waste in the conduct of business. It is vitally important that we stimulate business to produce for war purposes as economically and efficiently as possible, if for no other reason than to avoid a waste of war materials and labor and to hold down the cost of the war to the Government. Moreover, a post-war credit to industry will help toward the rebuilding of our economic life. For these reasons we have recommended a 90-percent excess-profits tax coupled with a 10-percent credit for return to the corporation after the war. The credit should, of course, be restricted in such a manner that it would be used for the direct employment of labor, the conversion of plant to peacetime business or for other uses promoting economic adjustment and growth.

3. *Tax on freight and express.*—One tax that would be imposed by the bill before you directly threatens the stability of prices. This is the tax on freight and express which would add to the cost of producing and supplying practically every commodity and service. In great numbers of cases the added cost would make it impossible for businesses to continue to operate under the price ceilings which have been imposed and the breaches in the price ceilings which would thereby be caused would threaten the whole price structure.

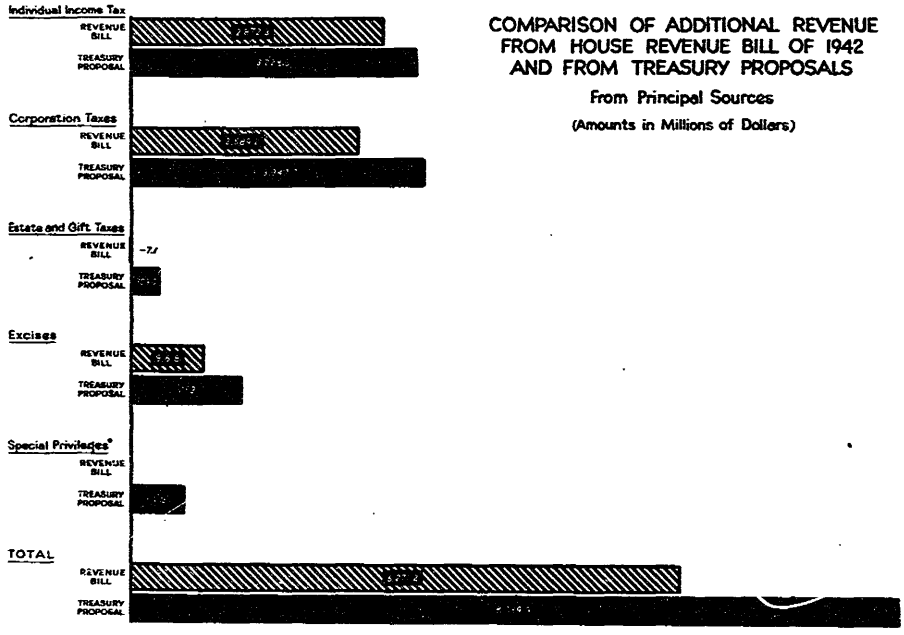
Conclusion.—I shall not attempt today to discuss the more technical aspects of the long and complex bill before you, nor to enlarge further upon the subjects I have mentioned already. The Treasury staff stands ready, as always, to assist you in every way possible in carrying out your difficult and responsible task. I should like, however, to make just one more appeal. Every day consumed in your committee's work will lose us substantial amounts of revenue under the excise tax portions of the bill. Every day that can be saved in enacting this bill will enable it to produce just so much more in needed revenue. Every day saved will give our citizens additional

time to adjust themselves to the impact of the most severe tax bill in all our history.

I am discussing our tax problem with you today on broader grounds than that of revenue alone. It is my conviction that the people of this country want a courageous tax bill, and want it with the least possible delay. They are ready for greater sacrifices than some of us imagine. The overwhelming majority of them, I am convinced, want us in Washington to show a determination that is worthy of their own. They will be critical of us only if we seem to palter or haggle, or if we pay too much attention to the demands of selfish groups, or if we seem half-hearted in asking self-denial of the people as a whole.

Our acceptance of sacrifice on the home front is a yardstick of our determination to win the war. For this reason it is unthinkable to me that we should be straining every effort on the fighting fronts abroad and on the production line at home, and at the same time be anything less than all-out in the financing of the war effort. This war, above all others, can be won only by hard fighting, by the acceptance of risks and deprivations and by the united effort of civilians and fighting men alike. In this kind of war a tax bill can be a decisive battle. It could be lost by narrow vision and faulty leadership. It can be won by boldness and courage. I am confident that this committee will live up to its high responsibilities and keep faith with a united people.

(The Secretary submitted the following chart:)


COMPARISON OF ADDITIONAL REVENUE FROM HOUSE REVENUE BILL OF 1942 AND FROM TREASURY PROPOSALS
From Principal Sources
(Amounts in Millions of Dollars)
Individual Income Tax
REVENUE BILL
TREASURY PROPOSAL
Corporation Taxes
REVENUE BILL
TREASURY PROPOSAL
Estate and Gift Taxes
REVENUE BILL
-7.1
TREASURY PROPOSAL
Excises
REVENUE BILL
TREASURY PROPOSAL
Special Privileges*
REVENUE BILL
TREASURY PROPOSAL
TOTAL
REVENUE BILL
TREASURY PROPOSAL
*Joint returns; interest on State and local obligations; and percentage depletion
Office of the Secretary of the Treasury
8-828-2

The CHAIRMAN. Any questions, gentlemen?

Senator BARKLEY. Mr. Chairman, I would like to make an additional observation following my interruption of the Secretary a moment ago. You and I discussed this subject of tax-exempt securities outstanding on many occasions.

Secretary MORGENTHAU. Yes, sir.

Senator BARKLEY. Both in public and in private.

Secretary MORGENTHAU. Yes, sir.

Senator BARKLEY. And I think you know the feeling that I have had about it. This is not a new subject. It has been debated here in every tax bill we have had for years, and before we got into the war, so it is not a new problem that has arisen. Undoubtedly we need the money and I am ready to vote to tax those securities if it can be done legally, but I would not be willing to vote for an allegal tax, if it is an illegal tax, just to get some money. There are a lot of other places we can get it, if they are legal. I am open-minded on the subject, and of course, will listen to the legal advice of the Treasury. We have gone along here for years and years taxing securities. We have taxed the incoming Federal securities and securities to be issued in the future, and I think it is fair to say if there had not been a legal doubt in the mind of Congress as to whether it could tax outstanding local securities they would have been taxed also. The only reason why they are not included now is the fact that there has been a legitimate legal argument about whether we can do it. If we can do it, I am ready to do it, and I want to do it, but I do not think the mere fact that we need that much money dissolves any honest legal doubt that anyone has as to whether we can do it legitimately. That is the position I take and it is one that has bothered me for a good many years, and I think it has bothered the committees of both Houses and both Houses of Congress.

I am sure you will present your side of the matter to the committee. As far as I am concerned, I am ready to listen, but I did not want any misunderstanding as to the views which I have entertained and which I still entertain and which have not been dissolved by the mere fact that we are in a war.

Secretary MORGENTHAU. Well, Mr. Chairman, if I may answer Senator Barkley——

The CHAIRMAN. Yes.

Secretary MORGENTHAU. I would not be coming up here again and again, asking that State and municipal securities be taxed, if we in the Treasury did not think it was legal.

Senator BARKLEY. I realize that.

Secretary MORGENTHAU. We are not coming up here asking for illegal revenue, at least from our viewpoint.

Senator BARKLEY. I understand that.

Secretary MORGENTHAU. If and when the chairman thinks it is proper, we would like to have the chance to present the Treasury's viewpoint as to why we think it is legal as well as ethical.

Senator CLARK. The only way to finally determine the legality is to submit it to the courts, and that could only be done by the Congress including it in some tax provision. Is not that correct?

Secretary MORGENTHAU. I did not get that.

Senator CLARK. I say the only way to finally determine the legality is by submitting it to the courts, and that could only be done by the Congress including it in a tax provision.

Secretary MORGENTHAU. I will ask Mr. Paul to answer that.

Mr. PAUL. You are quite right.

I might say, however, if it were palpably unconstitutional we would not come up here with it.

Senator CLARK. I know I voted for it repeatedly because I thought it was constitutional and legal. The only way that can be determined is by submitting it to the courts.

Mr. PAUL. We submitted it to the Attorney General. In the Ways and Means Committee hearings, there is incorporated, I might say, an opinion from Assistant Attorney General Clark stating quite clearly his opinion that there is perfect legality in the proposal now both as to outstanding and future issues. Nobody can blame Congress for not having done so in past years, because there has been, until recent decisions of the Supreme Court, a certain amount of doubt on this question.

I refer to the decision in such cases as *Graves* v. *O'Keefe* and the *Gerhardt case*. Those cases, in the opinion of the Attorney General, clear the thing completely. I am perfectly willing to submit a statement on that if necessary.

Senator TAFT. May I suggest the example given is not quite fair, because the gentleman who invested in tax-exempt securities was getitng only perhaps two-thirds of what he would have gotten if he had not invested in tax-free securities.

It can hardly be said that the figures used as an example are quite fair. I agree with the principle of it. It seems to me, in the interest of fairness, some account should be taken of the fact that he had to pay, in order to be exempted, more for the municipal bonds. The State and municipal governments received a great advantage from that fact in getting their money at a lower cost.

Secretary MORGENTHAU. No; no.

Senator TAFT. Therefore, in giving that as an example, it seems to me that a modification should be made in the figures here.

Secretary MORGENTHAU. No; Senator. We figure, going back over a number of years, that the tax-exempt privileges cost the purchasers about one-half of 1 percent.

I think the example is perfectly proper.

Senator DANAHER. Mr. Chairman.

The CHAIRMAN. Yes; Senator.

Senator DANAHER. Mr. Secretary, since we were talking earlier about a date, I would like to have your experts, then go into the matter specifically, give us your thought on our taking the date of January 23, 1942, for the reason that that was the date on which you first announced your intention of seeking this specific program. Certainly, everybody was put on notice as of that date that you intended to seek this tax, and any State bonds or municipal bonds then outstanding that were traded in thereafter were bought with notice to the purchasers of your intention to seek a tax on them. If we are to tax outstanding issues at all, it would seem to me you might very properly direct your thought to our taking that as a

specific date and saying that municipals thereafter traded in or issued would be subject to tax, but earlier issues still in the hands of owners would not be.

Secretary MORGENTHAU. That is approximately the date.

Senator DANAHER. That was the date?

Secretary MORGENTHAU. Yes; it was on January 24.

Senator TAFT. That would not contemplate the present or outstanding municipal bonds but only those in the future.

Senator DANAHER. Whatever we have a right to do in prospect—and I think that we have that right—and whatever we have an equal right to do as to securities outstanding as of that date and thereafter traded in, for the same principle would apply to both.

Secretary MORGENTHAU. As far as the Treasury is concerned, we certainly announced where the Treasury and administration stood on that point.

The CHAIRMAN. Is there any other question?

Senator DANAHER. I would like to ask the Secretary two or three other questions, if I may.

The CHAIRMAN. All right, Senator.

Senator DANAHER. Directing your attention to the first page of your statement, sir, where you discuss the achievement of a reasonable relationship of the income to the tax to be raised, relative to the $77,000,000,000 of expenses, I notice that the $8.7 billion revenue that you recommended to the House in the spring bore a relationship of 13.8 percent to the $63,000,000,000 of predicted expenses.

Secretary MORGENTHAU. Yes.

Senator DANAHER. What do you say should be a reasonable relationship? Would you apply the same formula of 13.8 percent to be raised by taxes?

Secretary MORGENTHAU. Well, that is a very difficult question to answer. I do not know what the date was when I appeared, I think it was before this committee, or probably it was before the House, but at that time, I hoped that we could pay 66⅔ of the expenses through revenue. Since then on the expenditures side, it has gone up so rapidly that it is very hard to state any particular percentage. I simply feel this way, that as far as the present time is concerned—and this is the best answer I can give you—that if the Congress would provide the 8.7 billion plus the 2 billion additional social security, I think that possibly for this year that would be a minimum now.

Senator DANAHER. Does the 77 billion include lease-lend expenditures?

Secretary MORGENTHAU. Yes, sir.

Senator VANDENBERG. Before you leave your percentage, Senator, if I may follow it up just a little, when you started on this tough journey in January, the objective was to pay two-thirds as we go, was it not?

Secretary MORGENTHAU. It was a year ago.

Senator VANDENBERG. It was a year ago?

Secretary MORGENTHAU. Yes.

Senator VANDENBERG. Now, as I understand it, it is about one-eighth pay as you go?

Secretary MORGENTHAU. A little less than 30 percent, just under 30 percent.

Senator VANDENBERG. Does not that shift the primary importance of our fiscal problem from taxation to borrowing? I do not mean that it lessens the need to get as much as possible in taxes, but does not that shift the emphasis to the necessity of a borrowing program, rather than a taxing program?

Secretary MORGENTHAU. Senator, you and I often do not state the same problem in the same way.

Senator VANDENBERG. I think that is an accurate historical outburst.

Secretary MORGENTHAU. I have learned through experience to look twice at your questions—also your letters. I would put it this way: I think it is very important that the Congress vote every dollar possible for taxes.

Senator VANDENBERG. How much do you have to borrow next year, I mean this fiscal year?

Secretary MORGENTHAU. Well, it is over fifty billion dollars, fifty or fifty-three billions.

Mr. BELL. $53,000,000,000.

Secretary MORGENTHAU. $53,000,000,000, Mr. Bell says.

Mr. BELL. $53 billion, on the basis of the latest Budget estimates.

Senator VANDENBERG. How much are you going to get out of voluntary bond purchases?

Secretary MORGENTHAU. The program calls for $12,000,000,000.

Senator VANDENBERG. You are not reaching it, are you?

Secretary MORGENTHAU. Not quite yet; no.

Senator VANDENBERG. Suppose we take the $12,000,000,000 that leaves $41,000,000,000 to be obtained somewhere else. Where will you get that?

Secretary MORGENTHAU. Well, we will get it from the insurance companies, the savings banks, individuals, trust funds, and the banks.

Senator VANDENBERG. Well, the normal purchase by insurance companies, and so forth, would be about $8,000,000,000, would it not?

Secretary MORGENTHAU. Mr. Bell will answer that.

Mr. BELL. About $2,000,000,000.

Senator VANDENBERG. How much?

Mr. BELL. About $2,000,000,000.

Senator VANDENBERG. Only $2,000,000,000?

Mr. BELL. Yes, sir.

Senator VANDENBERG. That leaves $39,000,000,000 then of forced sales to banks. That is what I am getting at. How much have you finally got to force into the banking system?

Secretary MORGENTHAU. Well, would you mind my saying that I think the word "force" is rather unfortunate?

Senator VANDENBERG. All right.

That is a post-Pearl Harbor word.

Secretary MORGENTHAU. Up to now, we have not had to use it.

Senator VANDENBERG. You use your own words. It is $39,000,000,000, about, that has to find its way into the banking system.

Secretary MORGENTHAU. I enjoy these exchanges with you always but what we have to borrow from the banks and the whole country is a very serious business.

Senator VANDENBERG. That is right. That is the reason I am inquiring about it.

Secretary MORGENTHAU. We have to look to the banks, and I told them so at their annual meeting. After we have gone to every other group of owners of money we, in the final analysis, will have to look to the banks to provide the money to finance this war. I want to say here, Senator, that up to now—that is why I just question the word "force"—the banks have been perfectly grand about this thing.

There has not been any question of force. They have bought Government bonds cheerfully and willingly and in a big way, and I think from every standpoint they should get full credit for it.

Senator VANDENBERG. You are convinced that it is safe to continue to avoid a more general allocation of these Defense bonds among the masses of our people and that it is still safe to concentrate these bonds in the banks?

Secretary MORGENTHAU. Let me put it this way, Senator: Within the limits of my ability to look ahead on this tremendous program, and I realize the size of it and also the limits of my ability, for the rest of this year my answer to you is it is safe. If, on the other hand, I change my opinion and feel that the program that we are following now in borrowing and financing is in error, that my judgment has been in error, I will come up here and say so and ask for assistance and guidance.

Senator VANDENBERG. Thank you. I will return you to Senator Danaher, but I would like to have you come back to me again a little later.

Senator TAFT. Mr. Chairman, I would like to follow up this question.

As I understand the Secretary, he is saying that the war has to be financed by selling—I did not get the exact figure—over $30,000,000,000 of bonds to commercial banks. Is that correct?

Secretary MORGENTHAU. Could Mr. Bell answer you, please?

Senator TAFT. I would like to have the Secretary's answer. It seems to me it is a vital question in national politics, if the Secretary is willing to say so.

Secretary MORGENTHAU. I am willing to back up Mr. Bell. He has got this thing at his fingertips.

The CHAIRMAN. I think, Senator Taft, that you misunderstood the Secretary. He did not say that it would be necessary to go to the banks for this final balance of some thirty-billion-odd dollars. I do not think he intended to say that, and I do not think he did say that exactly.

Senator TAFT. That is what I understood him to say, and I would like to have him say whether that is the fact. The Senator from Michigan got it down to about $39,000,000,000.

I think there are other sources of sales that have been calculated, but I have not seen any estimate which reduces that below $30,000,000,000. I would like to find out definitely whether the program of financing the $77,000,000,000 of expenses includes the sale of $30,000,000,000 or more of bonds to the commercial banks.

Secretary MORGENTHAU. Would it be agreeable to the Senator if I let the Under Secretary state it, and then if he is not satisfied, he can question me?

Senator TAFT. Surely.

Secretary MORGENTHAU. All right.

Mr. BELL. I do not believe that you can draw any such conclusion from the figures that Senator Vandenberg arrived at.

He merely took certain classes of investors and added up what they might take during the year and then deducted that from the total. There are many other investors in this picture which we must reach. Those are mutual savings banks, individuals, corporations, trust funds, and fiduciaries.

I can take the total debt and show you where that debt was on June 30 and then take the increase in the debt during the past year and give you the percentage figures.

Senator TAFT. Mr. Bell, I was asking about the program of the Treasury for the coming year beginning the 1st of July.

Mr. BELL. The program is to sell every dollar of public debt that we can outside of the commercial banking system. How much that will be we do not know.

Senator TAFT. Altogether you have to sell $53,000,000,000, is that correct?

Mr. BELL. Yes, sir.

Senator TAFT. Do you count in that this $2,000,000,000 that you are selling to the social security fund? Is that taxes or borrowing?

Mr. BELL. That is borrowing.

Senator TAFT. That is borrowing?

Mr. BELL. Yes.

Senator TAFT. That is included in the $53,000,000,000?

Mr. BELL. Without any new law, there would be about $2,000,000,000 in that.

Senator TAFT. That leaves $51,000,000,000. Then there is the $12.000,000,000 in this program of Defense bonds, stamps, and so forth.

Mr. BELL. We hope that would be the minimum.

Senator TAFT. As a matter of fact, up to date, you haven't gotten anywhere near that?

Mr. BELL. Yes, I would say we are approaching it this month.

Senator TAFT. In March, for instance, it was only half a billion dollars.

Mr. BELL. When was that?

Senator TAFT. In March.

Mr. BELL. This is July. We are well on our way toward a billion for this month.

Senator TAFT. Assuming that will be $12,000,000,000, that leaves $39,000,000,000.

Then what are the other sources?

Mr. BELL. You have mutual savings banks, insurance companies, and all other investors in the country, such as individuals, trust funds, corporate funds.

Senator TAFT. They are not going to have an awful lot to invest after we get through with the tax bill; I mean those concerns.

Mr. BELL. They may have some reserves for depreciation and other purposes.

Senator TAFT. I am not speaking of the savings banks and insurance companies. Of course they have. I am talking about the private investor of large sums who is not reached by this Defense bonds program, he is not going to have a great deal to invest.

Mr. BELL. They may have more than we think.

Senator TAFT. What is your estimate?

Mr. BELL. I have no estimate. I would not undertake to estimate how much it will be.

Senator TAFT. You have an estimate of $2,000,000,000 for insurance companies.

Mr. BELL. That is right.

Senator TAFT. And mutual savings banks are what? A half billion?

Mr. BELL. Mutual savings banks took $476,000,000 of our debt during 1942. How much they will take in 1943 I cannot estimate.

Senator TAFT. To be liberal, you might allow a billion dollars.

Mr. BELL. That is right.

Senator TAFT. Those are the only savings institutions. $3,000,000,000 out of savings institutions?

Mr. BELL. Yes, that is about it.

Senator TAFT. That will reduce it to $36,000,000,000. Don't you think that $6,000,000,000 is a fairly liberal estimate for private investors of large sums and trust funds and the like?

Mr. BELL. They took $11,000,000,000 in the fiscal year, 1942.

Senator TAFT. How much?

Mr. BELL. $11,000,000,000 of our debt in 1942 went to other investors than the ones you have named.

Senator TAFT. Also the small investors?

Mr. BELL. That was outside the commercial banks.

Senator TAFT. I mean there was then no Defense bonds program. That included all of them?

Mr. BELL. There was a Defense program during last year.

Senator TAFT. The $11,000,000,000 included that?

Mr. BELL. Yes, sir.

Senator TAFT. That is what I thought. Don't you still think that the program calls for the sale of approximately $30,000,000,000 to commercial banks?

Mr. BELL. No, I would not say that.

Senator TAFT. Is not that the estimate of the American Bankers' Association?

Mr. BELL. Oh, you see estimates anywhere from $15,000,000,000 to $30,000,000,000.

Senator TAFT. From $15,000,000,000 to $30,000,000,000?

Mr. BELL. Yes.

Senator TAFT. And today the total holdings of Government bonds in commercial banks are about $38,000,000,000?

Mr. BELL. On June 30 the total holdings of commercial banks were estimated at about $26,000,000,000.

Senator TAFT. If they took $24,000,000,000, you are going to double their holdings in a single year, is that right?

Mr. BELL. Your mathematics are correct.

Senator TAFT. What I would like to ask is this: Does not the sale of bonds to commercial banks create just that much more purchasing power which will necessarily break down any price-control program?

Mr. BELL. Not necessarily, but it does lay the basis for inflation. All borrowing from banks is not, however, inflationary.

Senator TAFT. It creates $24,000,000,000 purchasing power against a steadily decreasing amount of materials and supplies to be bought by the people who have that money.

Mr. BELL. Senator, we realize the danger of that type of financing. That is the reason we are trying to put every dollar outside of the banking system.

Senator TAFT. I understand that. It seems to me that the program as a whole is completely inadequate to prevent the very inflation that the Secretary at length denounces and correctly renounces. It seems to me that it is so much more important than anything Mr. Henderson is doing and it is so nullifying anything he can possibly do that, unless the Treasury can present a more constructive program, the responsibility for inflation would rest more on the Treasury and not on the Congress or on Mr. Henderson.

Mr. BELL. Anything Mr. Henderson does to control prices and keep the money out of the spending stream makes that much more money available for investment in Government securities.

Senator BARKLEY. You do believe that the war can be financed, don't you?

Mr. BELL. It has got to be financed.

Senator BARKLEY. I am wondering if the Senator from Ohio can prove that it could not be.

Senator TAFT. I think that a much more extensive bond-selling program must be undertaken than anything we have heard from the Treasury yet. A program that leaves the sale of $30,000,000,000 of bonds to commercial banks destroys any hope they have of preventing inflation in that respect.

Senator BARKLEY. Let me ask you this: The people of the United States are going to be making about $30,000,000,000 more income this year than they did last year, $28,000,000,000 to $30,000,000,000?

Mr. BELL. Probably that.

Senator BARKLEY. Of course, a large part of that is due to the expansion of industry and due to the war. It seems to me incredible that out of that $30,000,000,000 of new income we could not dig up $8,000,000,000 to help finance this war by taxation.

Senator TAFT. That goes to the question of taxes and not to the question of bonds.

Senator BARKLEY. That goes to the question of taxes and it goes to the question of borrowing money, because the more money we can raise by taxes, the less we have to borrow.

I suppose any sort of large-scale borrowing program, whether the bonds are taken by the banks or by individuals, creates an inflationary situation.

Senator TAFT. I do not agree with the Senator at all. The sale of bonds to commercial banks is directly inflationary.

Senator BARKLEY. There may be degrees of difference, but any outstanding large-scale bond program is bound in some way to create an inflationary situation which you cannot control either by tax laws or by price control.

There is no way to avoid some of that, in my judgment.

Senator VANDENBERG. The question submitted by the Senator from Kentucky raises a problem which you have touched upon, Mr. Secre-

tary, on page 3 of your prepared statement, which interests me tremendously.

You say if this bill is passed as it stands, there will be 31,000,000 income tax returns in 1943 as against only 7,700,000 in 1940. That is an increase of approximately 23,000,000 income tax returns.

Now, is there any figure available to show how much of your increased tax revenue comes from the 23,000,000 new taxpayers, as compared to the 7,000,000 old taxpayers?

Secretary MORGENTHAU. I think we have those figures.

Senator VANDENBERG. Are they available?

I think it is a very important figure.

Secretary MORGENTHAU. Can Mr. Blough answer you?

Senator VANDENBERG. Yes.

Mr. BLOUGH (Roy Blough, Director of Tax Research, Treasury Department). Of course, changes took place in 1940 and 1941 and in the House bill of 1942, and the estimates would have to be made up specially. They could be made up but they are not available.

Senator VANDENBERG. I would like to know, because I think it goes to the fundamental question of whether you are reaching the inflationary hazard. I would like to know how much of this bill comes out of the 23,000,000 taxpayers and how much comes out of the 7,700,000 taxpayers.

Secretary MORGENTHAU. We will have that study made for you promptly and have it submitted here.

(The information requested is as follows:)

Estimated number of taxable individual income-tax returns and tax liabilities at levels of income estimated for calendar year 1942, under the revenue bill of 1942 (as passed by the House of Representatives, July 20, 1942) of (a) individuals taxable under the provisions of the Revenue Act of 1939 and (b) individuals made taxable by subsequent changes in income-tax provisions (including the effect of the revenue bill of 1942)

[Money amounts in millions of dollars; number of returns in thousands]

	Number of returns	Tax liabilities
Returns taxable under the Revenue Act of 1939	7,042	6,496.8
Returns made taxable by changes in income-tax provisions	19,258	1,420.3
Total	26,900	7,917.1

Source: Treasury Department, Division of Research and Statistics, July 23, 1942.

Senator DANAHER. Mr. Chairman?

The CHAIRMAN. Yes, Senator.

Senator DANAHER. Referring further to page 3 of your prepared statement, Mr. Secretary, we have figures as to how many who filed returns for the first time under the 1941 Act, were not required to pay any tax at all, do we not?

Secretary MORGENTHAU. Mr. Blough will answer that.

Mr. BLOUGH. Such figures may have been submitted for the record last year. I do not have them right at hand.

Senator DANAHER. It is my recollection that there were some 7,000,000 returns filed from which taxpayers you collected no revenue whatever. That is my recollection.

Mr. BLOUGH. You mean under the 1941 act, filing in 1942?

Senator DANAHER. Yes.

Mr. BLOUGH. Probably Mr. O'Donnell has some recollection on that.

Mr. O'DONNELL (Al F. O'Donnell, Assistant Director of Research and Statistics, Treasury Department). That is approximately correct, Senator. The number of individual income tax returns which were filed from January 1 to June 30 this year totalled 26,300,000, of which 17,700,000 were taxable returns and 8,600,000 were nontaxable.

Senator DANAHER. Is it not a fair conclusion that a further lowering of exemptions and increasing the number of taxpayers actually causes a larger payment to be made by those who were already taxpayers?

Mr. O'DONNELL. That is true. The lowered exemptions of the House bill, together with the higher levels of income this year, will make taxable this year practically all of the nontaxable returns of last year and, as you say, all previously taxable returns will pay a tax on the amount by which their exemption has been reduced.

Mr. BLOUGH. I think there will be approximately 27,000,000 taxable returns under the House bill.

Senator BARKLEY. In that connection, may I ask the Secretary whether he could furnish the committee the number of taxpayers in 1941 and 1942? You are comparing 1943 with 1940, but there has been an increase in 1941 over 1940 and another increase in 1942 over 1941.

Secretary MORGENTHAU. We will do that, Senator.

Senator BARKLEY. I think it would be interesting to know how many new taxpayers this bill brings in over and above the taxpayers for 1942, and then going back to 1940.

Senator VANDENBERG. I agree with that.

Secretary MORGENTHAU. If you wait a minute, we will have that now.

(The information requested is as follows:)

Number of individual income-tax returns (1040, 1040A, and fiduciary) filed, by calendar years in which filed

Year	Taxable	Nontaxable	Total
1940	4,048,619	3,989,388	8,038,007
1941	7,645,473	7,579,091	15,224,564
1942 (January through June)	17,688,219	8,617,981	26,306,200
1943 (estimated):			
Present law	19,902,000	6,979,000	26,881,000
Revenue bill of 1942[1]	26,930,000	4,643,000	31,573,000

[1] As passed by House of Representatives, July 20, 1942.

Source: Treasury Department, Division of Research and Statistics, July 23, 1942.

The CHAIRMAN. May I suggest that I think we will very much more intelligently get at this particular phase of the matter when we give consideration to the individual income taxes. Then the whole question will be before us and the experts of the Treasury can then furnish us the information directly on the point.

Now, we are dealing with general questions.

Senator DANAHER. Mr. Chairman?

The CHAIRMAN. All right, Senator Danaher.

Senator DANAHER. I would like to direct the Secretary's attention to page 7 of his prepared statement with reference to mandatory joint returns.

Secretary MORGENTHAU. Yes.

Senator DANAHER. I wish to ask him a question on which I would like to have a specific answer in due course.

Secretary MORGENTHAU. Yes.

Senator DANAHER. By way of preface, a woman certainly, it seems to me, ought to be able to have the avails of her own earnings, even though she be married. A woman ought to be able to have the income from an inheritance from her father or brother or her family because it is hers, even though she be married. But if there be cases of evasion of taxes where transfers have been made of property by a husband to his wife with the intent of evading taxes, we would reach right to the heart of the problem, and I think you are seeking to alleviate that in your recommendation.

Secretary MORGENTHAU. In part.

Senator DANAHER. Now then, is it possible for us to take a period and date it back, let us say, 6 years, or 3 years—make the year date arbitrary, for all of me—and say that any transfer that has been made within that period shall be prima facie construed to have been a transfer with an intention to evade, in much the same fashion that you say a transfer in contemplation of death is, prima facie, subject to a tax?

Secretary MORGENTHAU. I do not understand. You want that answered now or later?

Senator DANAHER. No; I do not necessarily want it now. I would like to have it considered, though, so that we, in due course, can go into the possibility of whether or not you can draw a dividing line between bona fide transfers that have existed long before this program was initiated, or even contemplated, and that type of transfers which obviously is made with the intention of evading tax payment.

Secretary MORGENTHAU. It is a very interesting question and our men will study it and let you know what, if anything, can be done.

The CHAIRMAN. Mr. Secretary, I would like to ask the Treasury to consider this on the question of taxing incomes from State and municipal securities, that is to say, whether you would not make very great progress toward the eradication of this loophole, this shelter against the income taxes, by confining your tax to future issues and by classifying, in the estate tax section of this bill, the incomes derived from bonds on which full taxes have not been paid? A combination of the two, it seems to me, might carry us a long way toward the objective that you have in mind and might obviate the frank, blunt decision that an outstanding State or municipal security should be now taxed. Regardless of the strict legal question involved it is difficult to say, in fact I do not believe we can say, frankly, that the general understanding of the American investor, up until very recent months, was not that a State or municipal bond issue for the purpose of carrying on the functions of government, was not, in fact, taxable, and he acted upon that in making his purchases.

So there is a principle of morality involved, I think, in frankly saying that we now propose to turn back and say because of the evolution in the decisions of the court we will regard as taxable outstanding State and municipal securities.

As far as future issues are concerned, that question is not presented. It seems to me that there is a legitimate ground for a legitimate classification of any property in an estate that has not paid its full taxes, or comparable taxes to other like income-producing property. I think, through a combination of the two, we might make some progress, or at least I hope so.

Secretary MORGENTHAU. We will be very glad to give it careful study.

Senator BARKLEY. May I ask the Secretary: In that connection, I believe you said in your statement here, that there are approximately $14,000,000,000 of these outstanding local municipal, county, and State securities.

Secretary MORGENTHAU. That is right.

Senator BARKLEY. At what rate are they being refunded?

Mr. PAUL. I have a schedule here on that.

Senator BARKLEY. We can go into details later.

Secretary MORGENTHAU. About one billion.

Senator BARKLEY. A billion a year?

Secretary MORGENTHAU. Yes.

The CHAIRMAN. Are there any other questions for the Secretary?

Senator VANDENBERG. I wanted to ask one general question as to tax sources. I notice the Secretary's enthusiasm, on page 2 of his statement, for the Canadian and British tax record.

Are there any figures available to show how much of the Canadian program, which you so heartily applaud, comes from sales taxes, and also the same figure in relation to the United Kingdom?

Mr. PAUL. As for the United Kingdom, I can say offhand, because I remember, a very small proportion from sales taxes. I am not immediately cognizant of the figures from Canada. As a matter of fact, Canada has just revamped its whole tax system and our information from there is not complete.

Senator VANDENBERG. I understood that Canada got 17 percent of its revenue from general sales taxes.

Mr. PAUL. That might be right. I can check that figure for you. It will not be under the new, recently proposed Canadian measures, but it might have been up to now.

The CHAIRMAN. That is because the other taxes have been raised very greatly.

Senator CLARK. In the case of the United Kingdom, you do not have any such thing as a doubling-up of sales taxes. They do not have anything equivalent to our State sales tax. In other words, we have State sales taxes, many of our States have, and then we will have the Federal sales taxes, and we would be doubling our sales taxes. There are not any State sales taxes in the United Kingdom.

Mr. PAUL. That is right. The United Kingdom tax is a purchase tax. It does not have for its purpose the raising of money, but rather the discouragement of the purchase of certain commodities.

Senator CLARK. It seems to me one of the principal objections to levying a Federal sales tax is the fact that the States already have a sales tax, and it amounts to a cumulative sales tax.

Mr. PAUL. That is one objection, that the Federal Government would be, to a certain extent, invading the State field of taxes.

Senator CLARK. Certainly.

Senator VANDENBERG. I did not want to start any argument against the sales tax. I want to know how much of the Canadian system was operated on this basis. I understand the figure is 11.21 percent under the new law.

Mr. BLOUGH. That would sound about right.

Mr. PAUL. We will check it for you.

(The information requested is as follows:)

Sales-tax receipts in Canada and Great Britain for fiscal years ending Mar. 31, 1941–43: Amount and percent of total ordinary revenues

[In millions of dollars]

	Actual		Estimated, 1943
	1941	1942	
CANADA			
Sales tax	$185	[1] $236	$218
Total ordinary revenue	$860	[1] $1,481	$1,672
Sales tax as a percent of total ordinary revenue.....percent	21.5	15.9	13.0
GREAT BRITAIN [2]			
Purchase tax	$105	$394	$320
Total ordinary revenue	$5,635	$8,296	$10,508
Purchase tax as a percent of total ordinary revenue.....percent	1.9	4.7	3.0

[1] Preliminary.
[2] Pound converted at $4.

Source: For Canada, the House of Commons Debates, June 23, 1942; Great Britain, the financial statements for 1941–42 and 1942–43. Treasury Department, Division of Tax Research, July 24, 1942.

Senator VANDENBERG. It is a nice little contribution, is it not, Mr. Secretary?

Secretary MORGENTHAU. It all helps.

Senator TAFT. Mr. Chairman, just to get the figures straight, on the first page in the second paragraph of the Secretary's statement, the written statement says $77,000,000,000 and the Secretary said $75,000,000,000 when he read it. Which is correct?

Secretary MORGENTHAU. $77,000,000,000.

Senator TAFT. $77,000,000,000 is correct?

Secretary MORGENTHAU. Yes.

Senator TAFT. There is also a change on the second page regarding Canada. It seems to me you said 73 percent. Is the 70 percent figure correct?

Secretary MORGENTHAU. The statement is correct whatever it says—70 percent.

Senator TAFT. The written statement is correct?

Secretary MORGENTHAU. Yes. I must have misspoken.

Senator BARKLEY. Mr. Secretary, may I ask this question: Under the present bill, as it came to us from the House, you estimate that, roughly speaking, about $6,000,000,000 will be raised?

Secretary MORGENTHAU. Yes.

Senator BARKLEY. I noticed in the newspaper account on the bill yesterday that on account of some program to collect taxes at the source, that amount would be raised to approximately $7,000,000,000.

I do not see anything in your statement about it.

Secretary MORGENTHAU. Mr. Paul will answer you.

Senator BARKLEY. If there is such a hidden billion in there, it must be interesting to know how it is arrived at.

Mr. PAUL. I think that has nothing to do with collection at the source. That is only, after all, a method of advancing the collection. I think that disparity in estimates comes from a difference of view as to how much the national income will be. Although we admit the difficulty this year of making estimates as to future income, we think our estimates are substantially correct and the figure $6,300,000,000 revenue from this bill is a correct estimate. I want to say that is on the annual basis; that is not receipts for the fiscal year 1943.

Senator BARKLEY. How nearly correct was I a moment ago in the estimated $28,000,000,000 to $30,000,000,000 increase in the income of this year?

Mr. PAUL. There are so many ways of figuring national income and so much estimating about it, I think that figure is probably substantially correct.

Senator TAFT. What was the basis that you derived this $6,200,000,000 from? On the national income figure of $125,000,000,000?

Mr. PAUL. Mr. O'Donnell could answer that question. I think the answer would be we did not quite relate it to the national income.

Senator TAFT. I know that.

Mr. O'DONNELL. I remember the colloquy last year with Senator Gerry on the same point. In estimating the revenues, we estimate only those segments of the national income which are taxable.

Senator TAFT. You say that $77,000,000,000 is to be spent by the Government. How much is to be spent for civilian purposes?

Mr. O'DONNELL. I have not made a study of that. The Department of Commerce publishes from time to time the results of their historical compilations of what the national income, as they define it, has been. This definition excludes business taxes. I do not know just what the national income will be this year. Some people say $115,000,000,000. That figure may or may not be right.

Senator TAFT. If you only leave $50,000,000,000 for domestic consumption, which is very low, you would have an income of $127,000,000,000 necessarily, it seems to me, so that I should think $117,000,000,000 would be way under. You are not contemplating reducing the civilian consumption to $40,000,000,000, I do not think. I have not seen any such figure. That is far below the depression figure, or any figure that I have ever heard of.

Senator BYRD. Mr. Chairman.

The CHAIRMAN. Senator Byrd.

Senator BYRD. I would like to ask if that figure of $77,000,000,000 includes the disbursement of the corporations of the Government?

Secretary MORGENTHAU. Everything.

Senator BYRD. That includes the R. F. C.?

Secretary MORGENTHAU. Everything.

Senator GUFFEY. Mr. Secretary, in your excess-profits tax you recommend 90 percent and a 10-percent refund after the war?

Secretary MORGENTHAU. Yes.

Senator GUFFEY. Does the Treasury Department have any objections to increasing that to 100 percent with a 20-percent refund after the war to take care of unemployment?

Secretary MORGENTHAU. This 90 percent was arrived at after very careful consultation with the War Department, the Navy Department, Maritime Commission, and with Mr. Nelson. They all agree that the figure of 90 percent was the top figure that they could go to without these agencies that have to do the contracting feeling there might be a holding back on the part of the contractor. It is their unanimous opinion that 90 percent was as high as we could go without their feeling that they would have difficulty in making contracts for war purposes. So it was arrived at very, very carefully, after consulting all the Government agencies that do the buying.

Senator VANDENBERG. I would like to ask just one further question, Mr. Secretary, on general policy. You put great emphasis on the anti-inflationary importance of the tax action that we take.

Secretary MORGENTHAU. Yes.

Senator VANDENBERG. If I understand the criteria of the War Labor Board correctly, one of its two fundamental rules in granting the wage increases is that a corporation is in a position to pay the wages, meaning that it has the income. Any wages based upon that criterion are at the expense of your tax revenues, are they not?

Secretary MORGENTHAU. I do not think I understand you.

Senator VANDENBERG. Well, I mean that if wages are to be increased solely on the basis of whether or not a corporation has the income out of which to pay the increased wages, those increases are at the expense of what would be you ultimate tax target in that corporation.

Secretary MORGENTHAU. I do not think I could answer that question.

Senator VANDENBERG. I think Mr. Paul would be able to answer it.

Mr. PAUL. I think that any of these wage increases will be deductible by the corporations, assuming they are reasonable salaries. On the other hand, of course, they will be taxable income to the individuals.

Senator VANDENBERG. What I was trying to get at, if the anti-inflationary program was important in respect to this tax bill, haven't we also a fundamental interest in gearing wages to the entire anti-inflationary program, and can we hope, merely by the tax bill, to reach the objective until and unless we do gear wages into the entire anti-inflationary program?

Secretary MORGENTHAU. Well, Senator, I tried to make it clear—maybe I was not very successful—that I think, taxes, which are part of the Treasury's responsibility, are a very important part of the anti-inflation program. I do not believe that through taxes alone we can control inflation, or through our borrowing program alone can we either create inflation or control it. I can only speak for our own particular segment that has to do with taxes, and I want to say what you gentlemen do, and the rest of the Congress does, with taxes plays a very important part in the whole picture of inflation.

Senator BARKLEY. Whether the increase in wages would reduce the size of your target would depend somewhat upon whether the price of the product produced by the labor was also increased so as to add to the profits of the corporation.

Senator MORGENTHAU. That is right.

Senator VANDENBERG. All I am saying is that the whole thing is geared together and we cannot answer this thing solely through the tax bill, and very definitely that wage factor is involved.

Secretary MORGENTHAU. Oh, I think I can agree with you on that.

Senator VANDENBERG. Thus far we are not doing anything about it, are we?

Senator JOHNSON. Mr. Chairman.

The CHAIRMAN. Senator Johnson.

Senator JOHNSON. On page 6, the second paragraph, I want to take violent exception to the inclusion of mines. The need of ores is very critical. I think it is admitted that we must have certain ores in great abundance.

Senator VANDENBERG. You mean silver?

Senator JOHNSON. Well, silver comes in, too. It is a very important ore, as the Secretary himself has testified before the Special Silver Committee, but I am referring now more especially to zinc, copper, lead, and the long list of critical and vital minerals. The production of these minerals is definitely a war industry, the mining of these minerals is definitely a war industry. In other words, they are not mined when we are not at war, such as tungsten, vanadium, chromium, and some of the others, they are not mined extensively in peacetime.

First, may I say that the ore bodies have very definite limitations, and that is, I think, admitted by everyone. With the severe excess-profits taxes assessed it amounts to a confiscation of these ore bodies if they are mined during the war, and naturally a tax bill such as we have before us will definitely stop the mining of these critical minerals.

Secretary MORGENTHAU. No, I do not think so.

Senator JOHNSON. Yes, I think you will find it will absolutely stop it; it will put the red light against their operation.

Secretary MORGENTHAU. You do not mind if I differ with you?

Senator JOHNSON. Of course, that is your privilege, to differ; but the acquisition of these ores is very important to the war industry. As a matter of fact, it is one of the bottlenecks. It and transportation are the two bottlenecks in the war industry.

I wonder if the Treasury Department has given study and thought to a different method of taxing mining operations? We have submitted plans on several occasions and we have asked the Treasury to give study to a special taxation plan on mines and mining. I just wonder if any study has been made of the plans submitted to the Treasury Department?

Mr. PAUL. Senator Johnson, we have given a good deal of study to it and have had a great many conferences with representatives of the mining industry. There is in the bill a provision exempting bonuses which are paid on the theory that a mine is working extra and thereby cramming profits in one year, and where those bonuses are paid we are providing for an exemption from the excess-profits tax on the very theory that you have in mind, I think. We are still studying all phases of the problem. It is a very complicated one.

Senator CONNALLY. May I interrupt you there, Senator?

Senator JOHNSON. Yes.

Senator CONNALLY. Mr. Secretary, do you advocate in your testimony doing away with all depletion on all property?

Secretary MORGENTHAU. Mr. Paul will answer that.

Mr. PAUL. Nobody is advocating the disallowance of depletion on a cost basis.

Senator JOHNSON. I am glad to have your statement, Mr. Paul, about the bonuses. You believe that they should be exempt from excess profits?

Mr. PAUL. There is a provision in regard to that on page 217 of the Senate print.

Senator JOHNSON. Does the Treasury concur in the language of the bill?

Mr. PAUL. We did concur in that provision; yes, sir.

Senator TAFT. Mr. Chairman, may I ask a question?

The CHAIRMAN. Senator Taft.

Senator TAFT. Do I understand that in the recommendation of a higher tax the Treasury is now returning to its recommendation of the rates which it made to the House in every respect except the excess-profits tax which they have increased. Their former recommendation was 75 percent. Now are they returning, for instance, from 45 to 55 on normal corporation profits?

Mr. PAUL. The original Treasury recommendations, which embraced corporate combined normal and surtax of 55 percent, contained a system of excess-profits taxation which did not bring as high a yield as the 90 percent later advocated, so that it is not necessary to have a rate as high as 55 percent to get the corporate yield involved in the Treasury goal.

Senator TAFT. The Secretary deals in detail with these $600,000,000 increases in special privileges, but there is no statement here at all as to what the Treasury is now proposing definitely in the way of rates on corporation and personal income taxes.

Mr. PAUL. Of course, it is very difficult to say that, Senator Taft, because there are so many combinations. For instance, if you obliterated the freight tax, that would affect your rate if you wanted to attain the total goal. Our position is we think we ought to get from corporations approximately the amount that we asked for in the Secretary's original statement of March 3. If you accept a 90 percent excess-profits tax, such as is now contained in the bill, it will not be necessary to go to the 55 percent combined normal and surtax to get that goal.

Senator TAFT. What will it be necessary to do to get the rate to 50 percent?

Mr. PAUL. That must be tied in with the committee action on other points, too. For instance, the action of the committee in regard to percentage depletion will affect the corporate yield.

Senator TAFT. I notice there is an ignoring of it also in the individual income tax. Is the Treasury advocating a return to the rate they proposed on the individual income tax?

Mr. PAUL. Approximately; yes.

Senator TAFT. You are not satisfied with those in the House bill?

Mr. PAUL. No. We think this is one of the most important phases of the bill because it has the most bearing on the inflation problem. We think we ought to get at least the rate that we recommended before the House—I haven't the figure before me—which gives you

substantially more revenue than the House bill from individual taxation. Here I have to remind you that of course the corporate and individual problems are tied in together. The higher the corporate yield the less will be the dividends and the less will be the individual yields. So you will have to think of those two together.

Senator BARKLEY. Maybe Mr. Paul can answer this. I believe it is estimated by the Treasury that the mandatory joint returns would produce about $400,000,000. Is that true?

Mr. PAUL. That is true; but the Treasury suggested a device that we call the working wife credit. Now that does not completely tie in and does not completely relate to the question of mandatory joint returns per se. Without any working wife credit the joint return provision would add to the revenue approximately $420,000,000.

Senator BARKLEY. Now, then, the taxation of outstanding local securities would produce about a billion?

Mr. PAUL. About $200,000,000.

Senator BARKLEY. $200,000,000?

Mr. PAUL. That is right.

Senator BARKLEY. So that those two items would be $600,000,000?

Mr. PAUL. That is right.

Senator BARKLEY. You recommended a reduction in the income tax exemptions, which would produce about $1,100,000,000. How much of that was done in the House bill? The point is this: If these suggestions should not be adopted by the committee, have you some alternative proposals to raise approximately the same amount, so as to make this bill bring in approximately your original figure of $8,700,000,000, or in that neighborhood?

Mr. PAUL. We haven't any alternative proposals. We still think that, in general, the proposals we made are the most acceptable, and the best ways of raising this $8,700,000,000.

Senator BARKLEY. The committee may or may not agree to all the suggestions. If they should not—and I am not at all attempting to commit the committee, and I would not do that, I am not even committing myself—if the majority of the committee did not see fit to put the items in, have you some alternative suggestions, or will you have when the time comes?

Mr. PAUL. I would like to face that fact when we come to it, Senator. I hope we are not completely limited in resourcefulness if that happens.

Senator VANDENBERG. There are limitations.

Senator GERRY. Mr. Paul, have you sufficient information now from last year's tax bill to estimate how close the Treasury's estimates were in last year's tax bill? How accurate they were on the amount of money that would be raised?

Mr. PAUL. If I understand the question, there is no way of checking it.

Senator GERRY. I wondered if you had enough in from the returns in order to state that.

Senator TAFT. Mr. Chairman, is the Secretary satisfied with the exemptions stated in the House bill, or is the Treasury now proposing any change in those exemptions?

The CHAIRMAN. I was about to ask you, Mr. Paul, about the Treasury recommendations to the House Ways and Means Committee. Was the exemption of personal income $600 for a single person?

Mr. PAUL. $600 for a single person and $1,200 for a married couple, and $300 for each dependent. The action of the House was $500 for a single person, $1,200 for a married couple without dependents, and $400, which is the present rate, for each dependent.

The CHAIRMAN. Continuing the old rate on dependents?

Mr. PAUL. That is right.

The CHAIRMAN. How did that work out in dollars of revenue? How did the rates as fixed in the House compare with the Treasury recommendations in point of revenue?

Mr. PAUL. Including the effect of special provisions recommended by the Treasury, the individual income tax yield fell off $565,000,000 from what the Treasury recommended. Now, of course, a combination of factors enters into that.

The CHAIRMAN. Yes. You recommended higher rates, too.

Mr. PAUL. That is right; we recommended some higher rates, but a higher exemption also with respect to single persons.

The CHAIRMAN. What I was trying to ascertain was whether or not the rate schedule on individual incomes, that is, personal exemptions, did not work out approximately, in dollars and cents, when compared with the Treasury recommendations? In other words, whether the loss by the House bill under Treasury recommendations was not due very largely to the fact that the House did not go up on the individual rates?

Mr. PAUL. It was due to that, and it was also quite materially due to the $400, a continuation of the $400 allowance for each dependent, which is a quite material factor.

The CHAIRMAN. That is a big factor.

Mr. PAUL. It is.

The CHAIRMAN. And the dropping down of the exemption for unmarried persons did not compensate for it

Mr. PAUL. That is right, Senator.

Senator TAFT. Is the Treasury recommending going back to the original recommendation?

Mr. PAUL. We still think the best exemptions are $600, $1,200, and $300 for dependents.

Senator BROWN. Mr. Chairman, I would like to make an observation.

The CHAIRMAN. Senator Brown.

Senator BROWN. I am very much interested in the recommendation of the Treasury with respect to the elimination of exemptions on State and municipal bonds. As the Secretary recalls, we had a special committee on that subject, I think in 1939, when the last fight upon that subject was made. My recollection is that the committee divided 3 to 2 on a constitutional question. I think we were 4 to 2 in favor of the elimination of future isues from tax exemption. I believe the Senate did not agree with us on that proposition.

We were unanimous, Mr. Secretary, in the view that we should not tax outstanding issues. As far as I can recall, in none of the amendments that have been proposed since I have been here, and I think there have been three since 1932, was it proposed to eliminate outstanding issues.

Senator CLARK. The Senate adopted an amendment in 1933 to take up those issues.

Senator BROWN. That was before I was in the Senate. I do not recall it in the House.

Senator CLARK. It was sent into conference.

Senator BROWN. I say this, Mr. Secretary, I think there is a new argument for taxing outstanding issues, right along with the question submitted by the chairman of the committee, and that is this: When those issues were made by the States and municipalities, the income-tax rates were so much less than they are at the present time that an advantage is obtained by the holders of those issues that was not at all contemplated by them and was not paid for by them, and was not contemplated by the States and municipalities when the issues were made.

Now, it seems to me that it would be somewhat unfair to eliminate entirely the advantage that they thought they were buying at the time they purchased these bonds, and that some consideration should be given to that point in any future statement that you make to us, but that there ought to be some rate or some means provided whereby we could tax those bonds.

I note in the case you give that this man who made $975,000 paid a tax of $143,000, but if it were not for the tax exempts he would pay something in the neighborhood of $833,000, or he is paying approximately a rate of 85 percent. I am fully satisfied, from what I know about the subject from our investigation 2 or 3 years ago, that he did not contemplate, at the time he bought the securities, any such advantage as that. If we can eliminate the advantage which was not fairly contemplated at the time and still leave to him what we should, I think there might possibly be a chance to get somewhere. I, myself, do not feel that I could back a proposition that would entirely eliminate the advantage that he thought he bought at that time, but the great increase in advantage ought to be eliminated, and I do not think it is unfair to do so. If it can be worked out in such a way at all, I, for one member of the committee, would be in favor of it. I would like to have Mr. Paul comment on that.

Senator CONNALLY. May I ask you a question there? You spoke about the advantage he got when he bought them.

Senator BROWN. Yes.

Senator CONNALLY. Was not the main advantage that he got a protection against the very thing you suggest—the hazard of getting an increase in taxes?

Senator BROWN. I say the normal hazard he did contemplate, but he did not expect we were going to have anything like these enormous taxes that occurred after Pearl Harbor, if I may use that statement.

Senator CONNALLY. He did gain some tax advantage.

Senator BROWN. No such advantage as enjoyed by reason of the tax exemption at the present time. That, in my mind, is the only justification in going back and taxing outstanding issues.

I may say, as a practical proposition, the great opposition to it came from the State and local associations, the Association of Attorneys-General and so on. Of course, they are not particularly interested in the taxation of outstanding issues, they are interested in the taxation of future issues.

We might not have that opposition to a proposal such as you make. I think, to be fair, we cannot just simply tax them all. I think we

cannot give them the advantage that they thought they were buying. I realize it is difficult to draw the line, to say just where that is. If it could be done, and I think it can be done with reasonable fairness, there is, in my judgment, justification for taxing outstanding issues to that extent.

Senator BARKLEY. There is associated with that idea also an advantage that the people were getting in the lower rate of interest on their municipal and State bonds which, of course, had to be reflected in local taxation to raise the money to pay interest and the principal on the bonds. I think it has been estimated that, in all probability, the rate of interest the people paid on these local bonds is about one-half of 1 percent lower than it would have been if they had not carried the tax-exempt privilege.

So there has been that advantage to the people because of tax exemption and the lower rate of interest.

Senator BROWN. 1.25 is what our committee found was the difference.

Senator BARKLEY. In other words, your commitee found that it is greater than the figure I gave.

Senator BROWN. 1.25 was the amount of advantage.

Senator BARKLEY. You mean 1¼ percent interest?

Senator BROWN. That is right.

Senator BARKLEY. So that a municipal bond that is now tax exempt that bears a 3-percent rate of interest would have borne 4¼ percent if it had not been for the tax-rate exemption.

Secretary MORGENTHAU. Senator Brown, this may not be a very good example, but if I bought an automobile a couple of years ago, I thought I would get all the tires and gasoline necessary to run it, but I am not going to.

Senator VANDENBERG. There is not anything in the Constitution on that subject.

The CHAIRMAN. Are there any other questions?

Senator CLARK. Mr. Secretary, how much revenue is involved in this tax on freight? Have you got an estimate on that?

Secretary MORGENTHAU. Yes; I think we have it.

Senator CLARK. I think it ought to be stricken out, but I think we should know what it would be.

Mr. PAUL. The gross figure was about $290,000,000. Then we reduced the tax on coal, and then the gross figure was $252,000,000.

We have to take the net figure, because that tax is a deduction you see. So the net losses in revenue will be only $163,000,000.

The CHAIRMAN. Are there any further questions of the Secretary?

Senator DANAHER. Mr. Chairman, just one.

Last year the Secretary recommended to us a selected manufacturers' excise tax. Did the program work out to your satisfaction on the selected excise taxes then recommended?

Secretary MORGENTHAU. I think so.

Senator DANAHER. It did?

Secretary MORGENTHAU. I think so, as far as I know.

Senator DANAHER. Does it make you feel any more kindly toward extending the principle to include the general manufacturers' excise tax?

Secretary MORGENTHAU. Well, the two things do not necessarily follow. This year the taxes that we selected to increase had a direct bearing with the war effort and with inflation. We tried to select those taxes where we thought it would help the whole economic program.

Senator BARKLEY. Let me ask you this: Probably you cannot answer it now but maybe you can do so later. Have you made any comparison between the effect of a manufacturer's sales tax and the lowering of the exemptions among the lower brackets as it would affect purchasing power and therefore inflation?

Mr. PAUL. We have studied the effect of lowering the exemptions and the effect of the sales tax in respect to inflation. The answer is somewhat complicated. I do not know whether you would want to go into it now.

Senator BARKLEY. No; we would not want to go into it now. I assume if you made the comparison it might be worth while to look into it. I suppose both of them would curb purchasing power to the extent that they would have to pay more for what they bought and also pay more taxes on the reduction in the lower brackets.

Mr. PAUL. That is right.

Senator CLARK. Mr. Secretary, when the Office of Price Administration increased the price of gasoline 2½ cents a gallon, that had precisely the same effect on transportation charges in the correlated field that the tax on transportation that was included in the House bill had in the related field, did it not, except the Government did not get the money?

Secretary MORGENTHAU. May Mr. Blough answer that?

Senator CLARK. Yes.

Mr. BLOUGH. The effect, when applied to commercial transportation, is substantially the same.

Senator CLARK. That is what I want to get at.

Mr. BLOUGH. Yes.

Senator CONNALLY. Is everybody through?

The CHAIRMAN. Yes.

Senator CONNALLY. I would like to ask him a question.

The CHAIRMAN. All right, Senator Connally.

Senator CONNALLY. In your views about the mandatory joint return on all income, whether from the husband or from the wife, some mention was made about the provisions you had in mind about the woman's earings. What is that?

Secretary MORGENTHAU. May Mr. Paul answer you on that?

Senator CONNALLY. Yes.

Mr. PAUL. That is not in the Secretary's statement. I referred in passing, in answer to some question about the yield of that provision, to what we call the working-wife tax credit. The credit consisted of 10 percent of the earnings of a wife with a maximum limitation of $100. The theory of the credit was where two people of the family work, there is some additional expense as compared with the family where the woman in the family, in the general case, can stay at home.

Senator CONNALLY. How about the husband? Does he get any deduction?

Mr. PAUL. If he has the smaller income.

Senator CONNALLY. Your position is on the mandatory joint return that no matter where the income comes from, whether it is from the husband or the wife, it must be put into a single return and a tax paid on that individual income?

Mr. PAUL. It must be put in a single return, but the tax liability is apportioned as between the husband and wife. There is no attempt to impose a tax on the wife that should be borne by the husband's earnings, and vice versa.

Senator CONNALLY. Now, I do not get you. I thought your theory was you put it all in one lump sum and paid the tax just as if it were an individual.

Mr. PAUL. You put it in one lump sum for the purpose of computing the tax, and then when you come to the imposition of the tax liability, you divide the liability between the husband and wife in accordance with their respective incomes.

Senator CONNALLY. It is still the same tax. The family has to pay it; is that right?

Mr. PAUL. The two of them pay the tax on the family economic unit income.

Senator CONNALLY. You do not let them settle that matter themselves?

Mr. PAUL. We have no objection to their settling it.

Senator BARKLEY. Mr. Chairman, the Senate will probably be in session only a short time. They will call a brief calendar and probably adjourn until Monday. So if the committee wants to go ahead and finish the hearings, it will not interfere with the Senate.

The CHAIRMAN. I was about to ask, there is no need of keeping the Secretary any longer this morning? If there are further questions of the Secretary, they should be asked now.

We would like to have the staff remain here perhaps, or come back this afternoon.

Senator VANDENBERG. I would like to have your figure as soon as possible showing the division of income between new taxpayers and old taxpayers.

Secretary MORGENTHAU. Yes.

Senator TAFT. Mr. Chairman, there is a new idea on this joint return here stating that the family unit is a proper unit of taxation. Does not that principle give a tremendous advantage to the single man or single woman over the married people? If we change from an individual basis to a family unit basis, then why does not that give the single man a tremendous advantage?

Mr. PAUL. I do not see how it does, Senator. Perhaps I do not understand your question.

Senator TAFT. Well, it seems to me it costs at least twice as much for two to live as one. I think it costs more in the higher brackets. It seems to me if you shift the whole thing to the family unit and the family unit consists of one person, that that one person gets a tremendous advantage, he has much more left to live on than the family has.

Mr. PAUL. If I understand you, you are premising your question now on the idea that it does cost more for two to live than one.

Senator TAFT. No; it costs twice as much. It seems to me if you want to eliminate this injustice the thing to do is to go back to the

individual basis and let the families divide their income between husband and wife equally, as they do in the community-property States, and then raise your rates if you please, to the point where you get the same income or whatever may be necessary. It seems to me that is a much more equitable way to deal with this proposed injustice than it is to throw the husband's and wife's together, no matter where their income comes from.

Mr. PAUL. That is another way to get at the problem, Senator, but it does not seem to be quite satisfactory. We have given a great deal of study to that.

Senator BROWN. Mr. Paul, what did the House do as to section 402 in regard to community property?

Mr. PAUL. The House did not accept our ideas on joint returns.

Senator BROWN. It passed something.

Mr. PAUL. That was in respect to the estate tax. They passed a provision to the general effect that a community estate should be treated like a joint estate.

Senator BROWN. It relates solely to the estate?

Mr. PAUL. That is right.

Senator CONNALLY. You say it is on a family basis. As a matter of fact, it is not on a family basis at all. Suppose there was a man and wife and they had a son that has a million dollars. You do not include his million dollars?

Mr. PAUL. That is right.

Senator CONNALLY. Although you give them $400 to help support him. It is not a family basis at all, it is just husband and wife.

Mr. PAUL. It is true that we have not been able to find a satisfactory way of including all the family income; that is, the family income of children.

Senator CONNALLY. If you have a right to assess the wife's income as part of the husband's income, why haven't you got the power and right to assess the income of a son and daughter as long as they are single.

Mr. PAUL. I do not think it is a question of right.

Senator CONNALLY. Use the word "power" instead of "right." You could do it, could you not?

Mr. PAUL. If you can do one, you can do the other.

Senator CONNALLY. Exactly.

Mr. PAUL. We have not been able to work out a satisfactory scheme of including the income of children in the joint return.

Senator CONNALLY. Why? You say you cannot get one that is satisfactory. What is the difficulty? It would have the effect, along the line of the question of some other task, of taking the side of birth control, would it not?

Mr. PAUL. Well——

The CHAIRMAN. If it is the pleasure of the committee, we will recess until 2 o'clock, and ask the Treasury staff to come back here, and Mr. O'Brien. We may wish to ask a good many questions.

Mr. Secretary, we thank you for your appearance. It will not be necessary for you to come back.

Secretary MORGENTHAU. Thank you.

(Whereupon, at 11:55 a. m. the committee recessed to 2 p. m. of the same day.)

AFTERNOON SESSION

(Pursuant to adjournment for the noon recess, the committee reconvened at 2 p. m.)

The CHAIRMAN. The committee will come to order. Mr. O'Brien, will you come around and help us this afternoon?

Senator VANDENBERG. What is he going to do, go through the bill?

The CHAIRMAN. Mr. O'Brien, will you sit down, please, sir. You have not been coached as a witness, but I presume you are ready to go on and if it pleases the committee, I thought that Mr. O'Brien might briefly state the material changes made by the House bill in the existing law; and in connection with his statement, there may be questions that some members of the committee will wish to ask of the Treasury representatives. Mr. Paul is here and the other representatives of the Treasury Department; and so we will proceed, if it is the pleasure of the committee, in that way this afternoon, so that we may have a better understanding of the bill.

Any question that any Senator wishes to ask the Treasury staff about any feature of the bill may be asked as Mr. O'Brien develops it.

All right, Mr. O'Brien.

Mr. O'BRIEN. May I say, Senator, that I won't go into this in a detailed sense at all.

The CHAIRMAN. Not at all.

Mr. O'BRIEN. I will generally touch on the high spots.

The CHAIRMAN. Yes; unless some technical question develops which may be explained then by the Treasury staff or by Mr. Stam.

STATEMENT OF JOHN O'BRIEN, OFFICE OF LEGISLATIVE COUNSEL, UNITED STATES HOUSE OF REPRESENTATIVES

Mr. O'BRIEN. I might state, briefly, that the bill is divided into six titles; the first is Individual and Corporation Income Taxes, which consists of two parts, first, the part which relates to chapter I, that is, ordinary individual and corporate income taxes and part II which relates to personal holding companies; title II of the bill relates to changes in the excess-profits tax; title III relates to capital stock and declared value excess-profit taxes; title IV is Estate and Gift Taxes, consisting of two parts, part I relating to estate taxes and part II relating to gift taxes.

Title V relates to amendments to prior Revenue Acts and miscellaneous provisions, and title VI relates to excise taxes.

First, we will take title I, which begins on page 6, line 7, part I, Amendments to Chapter I—that is, ordinary individual and corporate income taxes.

First in section 101, which makes the provision of the amendments made by this title applicable only to the years beginning after December 31, 1941. That is the general rule—the rule which was first announced in 1934. The amendments are applicable to taxable years which begin in this year, or beginning thereafter. There are exceptions to that provision.

I shall call your attention to the various sections which are made retroactive, as we come to them.

Senator VANDENBERG. At this point, what is this general objection that I hear frequently, that you have increased the burden in respect to corporations that have a different fiscal year?

Mr. O'BRIEN. That comes under section 108, Senator, and would you mind holding that for a moment until we can get to it, sir? That is an exception to the general rule and a very important one, to be sure.

Senator VANDENBERG. And a very bad one.

Mr. O'BRIEN. Page 6, line 15, section 102 relates to normal tax on individuals. The normal tax rate is raised from 4 to 6 percent by this provision.

Page 7, line 1, begins the "Surtax on Individuals," and here the surtax begins at a surtax net income not over $2,000 at the rate of 13 percent and runs up to a rate of 82 percent of the excess over $200,000. The important thing about that schedule is that under the present law the lowest bracket is 6 percent instead of 13 percent, and the highest bracket under the present law begins at $5,000,000, whereas this begins at $200,000.

The CHAIRMAN. In other words, the maximum tax is applied after $200,000 has been reached in this case?

Mr. O'BRIEN. Yes, sir; $200,000 here, as against $5,000,000 under the present law.

Senator CONNALLY. Mr. O'Brien, may I ask, in the matter of individual taxes, is there anything comparable to the excess-profits taxes in the case of corporations or does that excess of such corporations apply to individuals as well?

Mr. O'BRIEN. It relates to corporations alone.

Senator CONNALLY. Exactly. Now why should a man whose normal income from a business is, say $50,000—why should he pay only the same rate as some man who makes $50,000 here that he did not make a year ago, and out of war contracts or out of inflated business operations—why should not there be some device in this bill to tax higher, normal or higher surtaxes in some way, those unusual and uncommon profits that we all know that people are making. A man who may have been making five or six thousand dollars a year under normal conditions and normal times, pre-war times, here in war times, in 6 months, may be making $600.000 in war profits?

Mr. O'BRIEN. That, Senator, is a question of policy.

Senator CONNALLY. The reason I am raising the question is: Should there not be a way and can there not be some way worked out so that we can get back a reasonable amount of those profits for the Government?

Senator VANDENBERG. To apply the excess-profits theory to individual income.

Senator CONNALLY. Exactly; treat them as excess profits, even though they are individual, just as we do corporations.

The CHAIRMAN. That was applied in the First World War excess-profits tax, was it not—to individuals back in World War I?

Mr. PAUL. In 1917 the act applied to individuals, and in the 1918 act, the excess-profits tax on individuals was abandoned.

The CHAIRMAN. Abandoned after 1 year's trial.

Senator TAFT. I raised the same question 6 months ago with the Treasury Department, and to my recollection they agreed to the

theory but said that administrative difficulties were insurmountable, is that incorrect?

Mr. PAUL. I would not go so far as to say that I agree on the theory completely; I think there is much in the theory, but the second part of your statement is quite correct. We tried to work out an individual excess-profits tax but we found great difficulties.

Senator TAFT. You mean relating to business or individual incomes?

Mr. PAUL. We tried to look at it from the standpoint of individuals, without reference to business and increased taxation, and there were too many complications about it. We conclude, after our study of the set-up, that nobody would have been able to file so complicated a return.

Senator VANDENBERG. You mean the difficulty with the taxpayers, for comparative purposes?

Mr. PAUL. There would be a great fundamental difficulty in determining the differences between the normal increase, which would happen in the ordinary course of business at any time and increases of income which were attributable to conditions of today peculiarly arising——

Senator CONNALLY. Could you not go back and take, as you do in most cases, a 4-year term and arrive at an average by which you can determine an excess-profits tax? Here is an individual who has been going around making 4 or 5 thousand dollars a year and this war happens along—you see them every day, do you not—everybody knows the war did this when they suddenly jump to tremendous incomes, we all know that the war is directly or indirectly the contributor?

Mr. PAUL. Not in every case. Let me see if I can give you an example of the difficulties arising.

A man comes into my law office—say he gets $2,100 a year——

Senator CONNALLY. When he comes in?

Mr. PAUL. Yes; I mentioned that——

Senator CONNALLY. When he goes out you do not know how much he is getting?

Mr. PAUL. All right. I say that in 6 months or a year it would be normal to give him a raise because of good work, that would happen at all times. Now, how are you going to distinguish between that kind of an increase, that $600 a year that would normally be given, and an increase in income which was plainly attributable to conditions of the day? We tried to do it, by setting up an arbitrary percentage which might be comparable to the method employed with respect to corporations, but we found many complications with respect to items such as medical expense and unusual misfortunes that people might have; and then on the policy end of it we found some difficulty in explaining, at least to ourselves, why a man making, say, $4,000 a year should be taxed at a greater rate than another man making $4,000 a year.

Senator TAFT. Suppose you had a machine shop run by two fellows earning $3,000 a year apiece and last year one fellow was allowed to work half time—business was not very good—and suppose last year he made $1,500, and the other fellow was getting $3,000.

Mr. PAUL. That is one trouble.

Senator TAFT. Then this year, on any such tax as proposed, the one making $3,000 in both years would pay less than the man who made

$1,500 last year and $3,000 this year through business conditions alone and through no fault of his own.

Mr. PAUL. And furthermore, the man paying the bigger tax did not have previous earnings to accumulate funds with which to pay the tax.

The CHAIRMAN. Then, Mr. Paul, is it not true that finally, when we get into the higher income brackets, with these greatly increased earnings, these rates put in there are pretty steep?

Mr. PAUL. All above $200,000 is at 88 percent; that is, 82 percent plus 6 percent normal tax.

Senator GERRY. On individuals?

Mr. PAUL. Yes; and you must add to that tax——

Senator HERRING. Mr. Paul, is anything being put in there to take care of partnerships in this tax?

Mr. PAUL. We have discussed it but we felt that the same difficulties were present, such as what was their business investment capital, and so on, and there were many administrative difficulties that were encountered back in 1917 in the 1917 act.

Senator HERRING. Partnerships have increased rapidly because of that, even now.

Mr. PAUL. There is a certain amount of de-incorporation.

Senator CONNALLY. One more question: Under this theory of taxation we cannot discriminate, but we can classify, can we not?

Mr. PAUL. That is right, sir.

Senator CONNALLY. You can establish classes and then, within those classes, tax them different rates from other classes or classifications.

Mr. PAUL. That is right.

Senator CONNALLY. Has it ever occurred to you that sources of income might be used as a basis for classification, such as war contracts, or you could broaden it all you wanted—had you ever thought of that?

Mr. PAUL. Yes; we have, and you remember under the 1918 act, it had a special extra tax on income from Government contracts.

In the first place, we felt that it is almost impossible to distinguish in the kind of war we have today what is war income and what is not. We cannot tell.

Senator CONNALLY. That is where a comparison with former income would furnish some standard, at least.

Mr. PAUL. It would furnish some standard, I admit, in some cases, but we felt that the test was too crude to apply without great hardship generally.

Senator CONNALLY. That is true of all taxes. Any flat rate will catch someone inequitably in comparison with others, but that is no reason why we should have no tax.

Mr. PAUL. But there is a comparative degree involved.

Senator CONNALLY. I hope that you will study that further, during the course of the hearing, so that we can work out some way of getting these unearned and almost criminal profits that some people are getting out of this war.

I think we have only struck one or two little scratches, and we have many individuals and concerns getting unearned and undue profits out of this war, directly out of it.

I think if it goes on it will probably get worse, I don't know.

Mr. O'BRIEN. Beginning on page 8, line 1, is the provision relating to the so-called short form. You will remember that in the last revenue act there was a special section inserted to provide for short form of return. Individuals whose gross incomes did not exceed $3,000 and consisted wholly of salaries, wages, compensation for personal services, dividends, interest, rent, and annuities or royalties were in that group.

Now, in view of the fact of increased rate of normal and surtax, the amount of the tax in each of the $25 brackets in the schedule you see beginning on page 8, line 13, has been increased over the existing law for those who file short forms.

Other changes are made. First, instead of a $400 exemption for each dependent, for the purpose of the short form, the amount is made $440; second, the determination of the taxable status of the taxpayer under the present law is as of December 31 of the taxable year; that is, the determination of whether he is married, the determination of how many dependents he has, and who his dependents are, under the present law, is as of December 31. This bill proposes to make that date July 1 of the taxable year; that is, to determine the status of the taxpayer—whether he is married—for the purpose of the whole year, that determination is to be made as of July 1 of the year.

In addition to that, certain taxpayers who, under the present law are eligible to use the short form, are made ineligible by this bill. It will bar, first, taxpayers filing returns for a period of less than 12 months; second, one excluded taxpayer will be one who is on other than a calendar-year basis; that is, a fiscal-year taxpayer is not eligible to use the short form; the third major change is that a person whose spouse does not use this supplement, the short form, but files under the regular form, cannot file under the short form.

I understand that loopholes developed in the case of husbands and wives, where the wife took advantage of the theoretical deductions allowed under the short form and the husband who had the actual deductions got the benefit of them through using the long form, or regular form. This proposes to eliminate that by making it impossible for one spouse to use one type of form and another spouse the other type. Both must file the same type of form.

Senator VANDENBERG. Is this the point at which you reduce the exemptions, or does that come in somewhere else?

Mr. O'BRIEN. No; that is in connection with section 123, over about page 50.

Senator VANDENBERG. All right; go ahead.

Mr. O'BRIEN. Page 12, line 11, begins "Tax on Corporations," and I must explain, first, in connection with the tax on corporations that there is a different concept in this bill of the base of the tax, the base on which the tax is computed. Under the present law the corporate gross income minus deductions is the corporation's net income, and that is the basis upon which the normal tax is levied; but in the computation of the net income the excess-profits tax is allowed as a deduction for the purpose of arriving at normal tax net income and surtax net income, which is the base for the corporate tax.

Now, in order to explain the effect of the change, I must tell you a little bit about the new plan of excess-profits taxation. For the purposes of the excess-profits tax—that is, the amount which is sub-

ject to the 90-percent rate in this bill—the net income of the corporation is ascertained. That is the gross income minus deductions. For the purpose of computing the excess-profits tax there is allowed an excess-profits credit of 95 percent of the corporation base period earnings and a specific exemption of $10,000. To the amount of the net income that is left is applied a 90-percent rate of excess-profits tax.

Now, this bill proposes to tax at normal and surtax rates the amount of the corporate gross income minus deductions, and to allow a credit against net income of the amount on which the excess-profits tax is paid.

Let me give an example of it. Suppose a corporation has a gross income of $100,000, deductions of $40,000, thus making $60,000 net income. Suppose the corporation has a credit for excess-profits tax purposes of $30,000, the credit, plus $10,000 specific exemption, makes $40,000. Thus, the corporation pays the 90 percent rate on $20,000; that is, the difference between the $40,000 and the $60,000. This bill proposes that the net income which is not subject to excess profits tax—that is, the $60,000 minus the $20,000, or $40,000, shall be subject to the normal tax and the surtax on corporations.

Senator TAFT. Will you say that again?

Mr. O'BRIEN. Yes.

Senator TAFT. Just the tax.

The CHAIRMAN. In other words, you deduct the amount on which you compute the excess-profits tax.

Mr. O'BRIEN. That is right.

The CHAIRMAN. Rather than the tax itself.

Mr. O'BRIEN. Right.

The CHAIRMAN. And the balance is the amount on which you compute your normal and surtax.

Mr. O'BRIEN. Exactly right.

Senator TAFT. As compared to——

Mr. O'BRIEN (interposing). Take the case of the corporation with a gross income of $100,000. It has its deductions of $40,000; this gives it a net income of $60,000. Suppose it has average earnings credit of $30,000, and it has specific exemption which is free from excess-profits tax of $10,000: therefore, $30,000 plus $10,000, or $40,000, is subtracted from the $60,000 to get the adjusted excess-profits tax net income. That adjusted excess-profits tax net income, or $20,000, is subject to a 90 percent excess-profits tax.

Now, let's start again on normal tax. It has a gross income of $100,000, deductions of $40,000, thus leaving $60,000. It has been subject to a tax on $20,000. Under the excess-profits tax, that is. Therefore, from $60,000, you subtract $20,000, thus getting $40,000, which is the base for the tax for normal tax and surtax purposes.

Senator TAFT. As compared to the present law?

Mr. O'BRIEN. Under the present law?

Senator TAFT. You tax is figured on what figure?

Mr. O'BRIEN. You have no comparable figure; you must get what your excess-profits tax is.

Senator TAFT. On 90 percent, if it was 90 percent, you would deduct from $60,000 the $18,000, and that would leave $42,000, under the present law, instead of $40,000 under the proposed law?

Mr. O'BRIEN. Right.

Senator VANDENBERG. In any event, it would still be necessary to hire a tax accountant.

Mr. O'BRIEN. I am afraid so.

There has been no change in the normal tax rate on corporations except that the place where the difference between the normal tax rate on small corporations and big corporations, the so-called notch, has been set at $50,000 on normal tax, now making the point of difference between the large and small ones run up somewhat.

The CHAIRMAN. Under the existing law that is fixed at what?

Mr. O'BRIEN. Around $47,000, I think.

The CHAIRMAN. And this bill will take it to $50,000?

Mr. O'BRIEN. Yes, sir; in order to make it uniform with the surtax.

The next major change occurs on page 13, line 8, relating to surtax on corporations. I might say, of course, that in surtax net income as contrasted with normal tax net income, in the case of corporations, partially tax-exempt interest is included; and to the extent of such interest corporation surtax net income is larger than the normal tax net income. Apart from the technicalities relating to the credit for adjusted excess-profits tax net income, the major change made in this section is to apply—instead of the rate of the present law, 6 percent on the first $25,000 of corporate surtax net income and 7 percent on the remainder—a tax of 10 percent on corporation surtax net income not over $25,000 and a tax of 21 percent on corporation surtax net incomes over $50,000, with an equalizing tax in the case of corporations whose surtax net income is over $25,000 but not over $50,000.

Now, in the case of a large corporation—that is, a corporation with a net income of over $50,000—the present normal rate of 24 percent has not been disturbed. The surtax rate, however, has been raised from 6 and 7 percent to 21 percent, and that is where you get your combined normal and surtax rate of 45 percent.

Senator GERRY. Will you state that over again?

Mr. O'BRIEN. Yes, sir. Under the present law, the corporate rate on a so-called large corporation is a 24 percent normal rate, and that has been left undisturbed in this bill. Under the present law the corporate surtax rate is 6 percent on the first $25,000 and 7 percent on the excess over $25,000. For that rate, there has been substituted a 10 percent rate on surtax net incomes not over $25,000, and for corporations with a surtax net income of over $50,000, the 21 percent rate applies; so the effect is, on the large corporations, you have a combined rate of 24 percent normal and 21 percent surtax, thus giving a 45-percent rate.

The CHAIRMAN. You mean, by large corporations, corporations with net income over $50,000?

Mr. O'BRIEN. Yes, sir.

The CHAIRMAN. That is where the rate comes from, your 45-percent rate, combined rate?

Mr. O'BRIEN. Yes, sir.

Senator CONNALLY. Under the present law a corporation having only $10,000 net income does not pay any taxes?

Mr. O'BRIEN. Under the present law?

Senator CONNALLY. Yes.

Mr. O'BRIEN. No, sir; it pays a normal tax—15 percent.

Senator CONNALLY. Where does the $10,000 come in?

Mr. O'BRIEN. The $10,000 applies to excess-profits tax only. The $5,000 specific exemption under the present law is made $10,000 by this bill.

Senator CONNALLY. But you pay some percentage on all the net profits now; and under this bill you continue to pay?

Mr. O'BRIEN. Well, that is not quite true, Senator, to this extent: In the case of the corporation paying excess-profits tax the amount over the 90 percent excess-profits tax is not subject to any tax whatsoever.

Do I make that clear, sir? Because you get a credit for normal and surtax purposes of the entire amount upon which the excess-profits tax is based, so to the extent of 10 percent that income of the corporation is free of tax.

Senator CONNALLY. But it would be then pretty high.

Mr. O'BRIEN. Paying 90 percent on part, and 45 percent on the rest of it?

Senator CONNALLY. Yes.

Mr. O'BRIEN. Now, the rest of the amendments in this section are purely technical amendments relating to getting rid of the deduction for excess-profits tax which is in the present law, and various other amendments particularly in connection with the net operating loss, in order to make them come out right. You see, when you change the basis of corporate tax it involves any number of miscellaneous amendments throughout in order to make it all come out straight.

The next change is on page 18, line 8, which relates to tax on nonresident alien individuals. Under the present law, that tax is at the rate of 27½ percent, and in view of the increase in normal and surtax rates on residents proposed by this bill the rate has been made 37 percent.

There is a further amendment which is different from the existing law in the case of nonresident and alien individuals. Where, under the present law, the rate is increased, the increase is retroactive to the whole year, notwithstanding the fact that the method of collection by withholding at the increased rate does not begin until 10 days after the enactment of the act. The proposal we have here is that the new increased rate won't begin after December 31, 1941, but only after withholding at the increased rate begins. That takes effect, or begins, on the tenth day after the enactment of the act.

The CHAIRMAN. Where is the section that applies to incomes earned in foreign countries and paid by foreign countries to American citizens?

Mr. O'BRIEN. That is section 134, later on.

The CHAIRMAN. All right; go ahead.

Mr. O'BRIEN. A similar change is made in the case of foreign corporations. The rate has been raised from 27½ to 37 percent. Similarly, the rate of withholding on fixed and determinable incomes, that is, dividends and interest and rents and royalties, and that kind of thing, which the nonresident foreign corporations or nonresident alien individuals are taxed on at that withholding rate, is similarly raised from 27½ to 37 percent.

Senator VANDENBERG. And is there a relationship between that rate and the reciprocal rate with other countries?

Mr. O'BRIEN. There is one on page 20, line 3.

The CHAIRMAN. I think recently we negotiated a figure in the treaty with Canada, and I think the rate is affected by that treaty, so far as Canada is concerned.

Senator VANDENBERG. Go ahead.

Mr. O'BRIEN. That says that you cannot—these increased rates will not go into effect in violation of treaty obligations.

The CHAIRMAN. Protecting the treaties?

Mr. O'BRIEN. Yes, sir.

On page 20, line 7, is the first of a number of purely administrative amendments made by the bill, partly carrying out the policy which was announced in connection with the Revenue Act of 1941—the last revenue act, that there would be an administrative act which would plug the loopholes and relieve a good many hardships. This particular section relates to the taxation of annuity trusts.

Under the present law, the Supreme Court held that if a payment out of a trust was chargeable to corpus—that is, the capital of the trust—notwithstanding that it may actually be paid out of the income of the trust, nevertheless the beneficiary of the trust is not taxed when the amount is distributed to him. The trust itself does not get a deduction even if it does distribute, but the trust pays the tax on the amount.

This amendment proposes a more realistic approach, notwithstanding the fact that the amount payable to the beneficiary of the trust may be paid out of capital; if it is paid out of income, it is included in the income of the beneficiary and the trust gets the benefit of the deduction for the amount paid out.

This provision, as I say, is a little more realistic in its view of the situation, and further helps to close loopholes.

Senator BROWN. In that change, Mr. O'Brien, under section 101, that applies to the current year?

Mr. O'BRIEN. Yes, sir; it applies to the current year.

Senator BROWN. Is there anything unfair about that? It seems to me possibly that ought not to apply until next year.

Mr. O'BRIEN. That is a question of policy, Senator, and it could be postponed.

One thing I might call your attention to, in connection with that, Senator, under this amendment: If the amount is paid or distributed after December 31, 1941, it does not make any difference what taxable year the trust is on and what taxable year the beneficiary is on. You have to have it cut off—you have to have a cut-off date there somewhere, so this is not geared to any taxable year. It is entirely conceivable that a trust may have a taxable year beginning June 30, 1941, with a beneficiary whose taxable year begins January 1, 1942, This proposes, with respect to the year beginning June 30, 1941, the trust gets the benefit of a distribution in May 1942, and the beneficiary is taxed.

Similarly, if the trust had a calendar taxable year beginning January 1, 1942, and ending December 31, 1942, and the beneficiary had a taxable year ending June 30, 1942, the beneficiary would have to include the amount in his income and the trust would get the deduction.

Senator BROWN. Is it possible that might come in, on some case already started in a district court?

Mr. O'BRIEN. I don't think any of those cases would get that far, sir. In that respect, it is retroactive, for some people have already filed their returns for the taxable year beginning in 1941.

Senator DANAHER. That would apply to any type of beneficiary?

Mr. O'BRIEN. It would apply to any beneficiary of an estate or trust.

Page 21, line 18, is a purely technical amendment to make absolutely certain what was done when you subjected future issues of Federal obligations—subjected the interest on future issues of Federal obligations—to tax.

The bill makes perfectly certain that as to those issues that are issued after March 1, 1941, the taxpayer does not get a credit for partially tax-free obligations.

This clause may well have been put in before. Why it was not, I do not know, for there was no reason for not so doing; but the reason for putting it in now is to make absolutely certain that it accomplishes the purpose desired.

Page 22, line 14, extends the period of time during which incomes derived by corporations from the retirement of their own obligations may be excluded from gross income. By an amendment made in the Revenue Act of 1939 it was provided, in the case of a corporation which was in an unsound financial condition, if it retired its obligations at less than par, the difference between the issue price and the redemption price was to be excluded from gross income. Under the provisions of the 1939 Revenue Act that was made applicable only to taxable years beginning then and not beginning after December 31, 1942. This proposes to extend the period of time during which that relief may be allowed to corporations for 3 additional years; that is, years not beginning after December 31, 1945.

Senator CONNALLY. That only gives relief to the extent of the difference between the par value and the price at which they settled?

Mr. O'BRIEN. The price at which they redeemed.

Senator CONNALLY. If they paid the debt at par, they would not get anything of advantage?

Mr. O'BRIEN. Then they would not have any income.

The situation is, under the law as it now stands, if a corporation issues obligations at 100 and redeems them at 90, it has income of 10.

Senator CONNALLY. I understand that, but what I am trying to get at is, a corporation now that owes debts is making a plea that they should have some consideration—numbers of them are—and a little different treatment so that they can pay their debts rather than taxes, and pay their income, the bulk of their profits, not in the form of taxes, and thereby this would make it impossible to pay debts and would wreck the business.

I understand that the Treasury has been trying to work out some formula along that line. Have you got anything on that?

Mr. PAUL. There is nothing in the bill on that, no relief of the type you have in mind, Senator Connally. We have been working very strenuously on that matter and hoped that something might be worked out but we have not as yet been able to do anything about this situation.

Senator JOHNSON. Did you make a recommendation to the House, and they rejected it?

Mr. PAUL. I did not make a recommendation to the House, I simply filed a sort of an exploratory memorandum with the committee, and the committee took no action one way or the other.

Senator BROWN. Mr. Chairman, would it be possible——

The CHAIRMAN. You could do that very well if you had a post-war credit to be taken in bonds, or absorbed in debt amortization paper? If we could issue, say, post-war credits back to the individual corporations, that would make it easier to apply the principle that we desire so much.

Mr. PAUL. That is true, sir. We are very anxious to give some relief in this kind of a situation where a corporation is simply up against heavy debts, but every way we look we have found that we were creating discrimination between a person who saved by reducing debts and the person who had no debts and adopted some other form of saving.

Senator DANAHER. Mr. Chairman.

Senator BROWN. Mr. Chairman.

The CHAIRMAN. Senator Brown.

Senator BROWN. Would it not be possible for us to have a copy of the present law for comparison with the proposed bill?

I read section 22, and it does not mean anything to me.

The CHAIRMAN. I made that request of Mr. O'Brien and his staff, and he said it was practically impossible for him to do it, that there was not sufficient time.

Mr. O'BRIEN. I would like to have done it, sir.

The CHAIRMAN. We wanted that for the committee.

I think that Senator Brown is quite right because where an amendment applies merely to the Internal Revenue Code, unless we remember the entire Internal Revenue Code, which we do not, we have great difficulty in seeing just what you have done.

Mr. O'BRIEN. I can say, sir, that I wanted to make that effort for the committee, but unfortunately it is a fact that you would have to print, substantially at least, the entire income tax laws. You would have to print a great deal of them, and I would imagine that a comparison of that kind with this bill would run to some 800 or 900 pages in a comparative print.

We tried to do our best to educate by way of parenthetical expressions on each page. You will notice, beginning at page 22, line 17, "Section 22 (b) (9) (relating to exclusion from gross income of corporate income derived from discharge of indebtedness)." We tried to help along that way, but we just frankly threw up our hands over in the House. The House has done a stupendous job on this thing. This bill is perfectly enormous and it amends sections throughout the entire Internal Revenue Code.

Senator BROWN. I withdraw my request, sir.

Senator DANAHER. How far back do you go in making the last three lines on page 23 retroactive?

Mr. O'BRIEN. Page 23?

Senator DANAHER. Yes.

Mr. O'BRIEN. We have not come to that yet, Senator.

Senator DANAHER. Very well, I'll wait.

Mr. O'BRIEN. Let me tell you what it is, first.

Under the present law, there has been a good deal of confusion, until the Supreme Court by a recent decision decided that when a lessee of property puts real property improvements, such as a build-

ing, on the land and the lease is terminated, that building constitutes income to the lessor on termination of the lease. This proposes to say that in such case that amount does not constitute income to the lessor at the time of the termination of the lease. At various times in the history of the income tax, there have been somewhat conflicting rules, and it has been held that in cases in which taxpayers have taken the amount or value of the building up in income tax, then the value of the building is added to the basis for determining gain or loss, or the same basis for determining depreciation. This proposes to say if you have done that in the past, you keep the basis that you have; but proposes, with respect to future terminations, there is no increase in the basis whatsoever on account of the building coming back to the lessor.

Now, for years beginning before January 1, 1942, Senator, you apply the rule only in those cases in which as a consequence of being compelled to take the value of the building up as income or electing to adjust the basis, you are going to give them the benefit of that basis they acquired in the back years; so that in that sense it is retroactive.

Senator DANAHER. How far back in years?

Mr. O'BRIEN. Just as far back as you could go.

Senator TAFT. There is a question of perpetual lease for a building involved; say, a perpetual lease is a lease running longer than the life of the building?

Mr. O'BRIEN. Longer?

Senator TAFT. Yes; a perpetual lease. Who takes the depreciation?

Mr. O'BRIEN. The owner of the building.

Senator TAFT. The owner?

Mr. O'BRIEN. Yes, sir.

Senator TAFT. There has been no change?

Mr. O'BRIEN. No, sir; no change.

This only relates to the case where the building is put on your land by a tenant and comes back to you because of the termination of the lease. Under the present law that is income, though you might not have the money to pay taxes with. This proposes to say that there is no income on termination of the lease and the building has no basis for determining gain or loss, and you get no depreciation on it, because there is nothing to depreciate. When you sell it, you take up your entire gain, and it is taxable, and all realized gain is recognized.

Senator DANAHER. That is true for whatever reason the lease is terminated?

Mr. O'BRIEN. Yes, sir; it does not make any difference what the reason may be for which the lease is terminated.

The CHAIRMAN. That covers the cases of the railroads, where the lease may be terminated unexpectedly because of insolvency of the lessees and thrown back on the lessors?

Mr. O'BRIEN. That is true. You heretofore recognized this problem by excluding the amount of such income from excess-profits taxation. This says it is not income at all.

The CHAIRMAN. Yes.

Mr. O'BRIEN. Page 24, line 1, is another one of these administrative changes of which I spoke. It relates to bad debts, prior taxes, and amounts paid on account of taxes. It says that if you took a deduction for a bad debt in a previous year, and in that year you did not get any tax benefit on account of that deduction, if this year you made

a recovery on that bad debt, the amount of that recovery is not considered income in the year in which it was received.

Let us take an example. Here is a man who had a bad debt. The debt went worthless in 1929, let us say, when he had no income, absolutely no income whatever. Now, under the law of 1929 he was allowed as a deduction $100 on account of that bad debt but he didn't take that deduction for the reason that if he took the deduction it wouldn't do him any tax good at all, his losses from other sources were so great that he didn't have to pay any tax anyway.

Now, suppose that this year he can recover some amount on account of that bad debt. Let us say $10. He does recover $10. This says not having gotten the benefit of the deduction in the previous year you will not consider its recovery this year as income.

Senator CONNALLY. That would be a recovery of capital, would it not?

Mr. O'BRIEN. Yes.

Senator CONNALLY. That is on the theory that it is really recovery of capital rather than income.

Mr. O'BRIEN. Yes.

A similar provision applies with respect to taxes. For instance, you paid a tax during a previous year. You did not get the benefit of a deduction for a tax. For instance, a tax to a State. Now, you get a refund. You find you did not owe the tax. You find you didn't get the benefit of the deduction on account of the tax. You do not have the amount of the refund of the tax included in income.

A similar rule is applied in the case of recovery of amounts paid by reason of not filing a return or filing a late return.

Senator DANAHER. Would you amend your definition on line 14 to include amounts allowable as well as those allowed, or is this broad enough to include it?

Mr. O'BRIEN. Well, I have forgotten just how the debate raged back and forth about that word, Senator; I don't recall the details on it, but we did debate whether the word should be "allowable" or "allowed," and finally decided on "allowed." I should like to think about that again. I don't know why we said "allowed" rather than "allowable."

This provision is made completely retroactive.

Senator TAFT. If it was "allowable" and not "allowed" you wouldn't have a recovery, would you?

Mr. O'BRIEN. Probably so.

Senator TAFT. When you had collected a debt, there wouldn't be any recovery because you never took it off.

Mr. O'BRIEN. Maybe that is the answer, that you never took it off. As I say, I don't remember how the debate went.

Now, as I said, this is made completely retroactive back to the beginning of the revenue acts.

Page 27, line 1, excludes from gross income, in the case of an individual who is a member of the military and naval forces of the United States, so much of his compensation as a soldier or sailor or officer, as does not exceed $250 in the case of a single person and $300 in the case of a married person.

The effect of it is, by way of an exclusion from gross income, somewhat similar to allowing, in the case of a single person, a personal

exemption of $750, which is the same as the present law, and in the case of a married person, $1,200 which is the same as the present law.

Mr. PAUL. $1,500.

Mr. O'BRIEN. I beg your pardon; $1,500, which is the same as the present law.

One more thing about it. It relates only to what he gets from the United States. It does not relate to whatever income he may have from dividends or interest or rent or other sources.

Page 27, line 14——

Senator BROWN. Would you tell us what "C," under line 20, page 26, means?

Mr. O'BRIEN. "C"?

Senator BROWN. Yes.

Mr. O'BRIEN. "C" runs all the way back to the 1913 Revenue Act, Senator; makes these amendments applicable.

Senator BROWN. Does that mean that the Department can go back and reopen the returns for 1939, 1940, and 1941?

Mr. O'BRIEN. No. Returns which are closed by the statute of limitations aren't opened. You see, if this had been a part of the Revenue Act of 1918, if the return is closed, nothing can be done about it. That is the statute of limitations.

Senator BROWN. It seems to say that subsection A was the law in 1938, 1939, 1940, and 1941.

Mr. O'BRIEN. That is right. Suppose it was the law in 1924. Your 1924 year is closed, Senator. That doesn't do any good.

Senator BROWN. I didn't say 1924.

Mr. O'BRIEN. Well, you are assuming 1938 is closed or not closed?

Senator BROWN. Closed.

Mr. O'BRIEN. You are assuming 1938 is closed?

Senator BROWN. Yes.

Mr. O'BRIEN. This doesn't do the taxpayer any good.

Senator BROWN. I didn't think it did.

Mr. O'BRIEN. No; it does not. There is one point I want to call to your attention. Let me point this out, Senator. If 1938 is the year in which you took the bad debt deduction which did you no good, and that is a closed year, if you made a recovery of the debt in 1942, 1942 being an open year, you get the benefit of this provision. But if you took the bad debt deduction in 1924 and got a recovery in 1938, but both the years were closed, you don't get the benefit of this section.

Page 27, line 14, relates to the report requirement in connection with certain inventory methods. In the 1939 act, in the provision relating to the so-called last-in, first-out method of taking inventory, there was in connection with that change in 1939 a requirement that the taxpayer report to shareholders and report for credit purposes only on the last-in, first-out method. That requirement related not only to the annual report of the corporation to its shareholders or the annual report to its bankers, but also to so-called interim reports—that is, reports on a monthly or other basis to shareholders, and so on. This proposes to get rid of that requirement relating to the interim reports, so the taxpayer is eligible to use the last-in, first-out method, if he reports in his annual report on the last-in,

first-out method, notwithstanding the fact he may on the intermediate reports report on the first-in, first-out method or some other method of taking inventory.

This amendment is made retroactive to taxable years beginning December 31, 1940, to permit those who during 1941 submitted interim reports on the basis of other than last-in, first-out, to their shareholders or otherwise, to take advantage of the last-in, first-out method of inventorying for 1942.

Page 29, line 1, is the provision relating to alimony and separate maintenance payments. The provision, in general, is this, that if the husband is paying, let us say, alimony out of his salary, is paying his ex-wife $100 a month, they having been divorced, then the wife takes up $100 a month in her income, the husband gets a deduction for $100 on account of the payment to his wife. That is the simplest possible case.

Similarly, if the husband established a so-called alimony trust, which the Supreme Court has held is taxable to the husband, notwithstanding the fact all the income goes to the wife, it is proposed here that the wife will take up the amount of the income from the trust in her income as it comes to her.

Another major feature of this provision is that the lump-sum settlement——

Senator CONNALLY. In short, you allow the husband to take a deduction of what alimony he pays and she pays the tax on it?

Mr. O'BRIEN. That is it briefly, in the simple case.

Senator CLARK. Is that not substantially the same provision as in the last Senate bill?

Mr. O'BRIEN. Very similar to it. I think we put it in a little more streamlined language and elaborated on it a little bit.

Two more things I might call your attention to: First, in connection with the lump-sum settlement of a husband and wife. Let's say as a consequence of the decree of divorce or separation the husband gives the wife $100,000 and that is all there is to it. That $100,000, under this provision, is not income to the wife and is not deductible by the husband. It is only the periodic payments of alimony which is deductible by the husband and is income to the wife.

One other thing. If an amount is specified in the decree of divorce attributable to the support of minor children, that amount is not income of the wife and is allowed in connection with the credit for dependents of the husband if the husband is actually supporting the child. If, however, that amount paid the wife includes the support of children, but no amount is specified for the support of the children, the entire amount goes into the income of the wife and she gets the credit for the dependents if she does actually support the children.

Senator DANAHER. Suppose in a State where the wife has a statutory interest in her husband's estate, of which she cannot be divested by will or otherwise, and the court finds, in allocating so much of the husband's property to her, that this is her allocable share under the statute, or the equivalent, whether payable in installments or not—if the court so finds, wouldn't she be a purchaser for value to the extent that she is entitled to that share under the laws of that State?

Mr. O'BRIEN. My conception of that, Senator, is that that is a property settlement and being a property settlement rather than a

periodic payment for the support or in recognition of an obligation to support, is not taxable to the wife and not deductible by the husband. Like the case where there is an apartment house—or where they enter an agreement that her dowry is worth so much and he gives her that much.

Senator DANAHER. Well, until she does receive payments equal at least to the value of the estate she was entitled to take, isn't she a purchaser for value?

Mr. O'BRIEN. Well, regardless of whether she is a purchaser for value, I don't think she would be taxed on the amount she got when she got it. But I think this is true, say there was an apartment house, or securities, or something like that, if the income came to her from those securities, or from the apartment house, she would be taxed on that, but not on the capital sum which was given to her in consequence of the decree.

Senator DANAHER. And what is the principle on which you exempt from the operations of this section a lump-sum settlement.

Mr. O'BRIEN. It is not a periodic payment.

Senator DANAHER. So that the whole difference turns on whether or not she gets it all at once?

Mr. O'BRIEN. That is right. Now, there are statements here relating to installment payments.

The CHAIRMAN. What about a trust. Suppose you set up a trust. Is that considered a lump-sum payment?

Mr. O'BRIEN. If the husband has no right in it at all, and if it is the kind of a trust which under the decree of divorce is final and cannot be opened at all, under the present law the income is taxable to the wife. Under the present law, income of certain kinds of so-called alimony trusts are taxable to the husband. It is not taxable to the wife. But the income from the trust, which under the present law the Supreme Court would hold to be taxable to the husband, is now made taxable to the wife.

The CHAIRMAN. Income from the trust?

Mr. O'BRIEN. That is right.

Senator DANAHER. Do you intend that this shall be prospective only?

Mr. O'BRIEN. Prospective only.

There are rather elaborate rules here with respect to effective dates, and the effective dates with respect to which the amendments are applicable. It is geared to the wife's taxable year. That is, the husband gets deductions in the taxable year in which he pays if the payment falls in the taxable year of the wife which is subject to this act.

Senator DANAHER. I may have misled you. I want to make sure that I did not. I want to make clear whether you intend that the provisions of this shall apply retroactively to alimony arrangements entered into, let us say, in 1935?

Mr. O'BRIEN. It doesn't make any difference if it is entered into in 1902, if it is a periodic payment. Now, the time of the creation of the interest or the time of the divorce has nothing to do with it. People divorced 10 years ago are still paying a part of their salary to the wife. They will get the deduction, and the wife will take it up as income.

But I do want to make plain that the applicability of this section depends on the wife's taxable year. That is, if the income is paid in

a year when the wife will pay income tax on it, then it is deductible by the husband. If it is not, it is not deductible by the husband.

The CHAIRMAN. In other words, if she doesn't have sufficient income to get into a taxable bracket, it is still charged to the husband?

Mr. O'BRIEN. No, no. No matter whether she pays a tax on it or not, it makes no difference. It is just what year it falls in.

Let me give you a case, Senator: If the wife is on a calendar year beginning January 1, 1942, and the husband is on a fiscal year ending June 30, 1942, if he pays her the money in May 1942, since the amount which he pays falls in a year of the wife to which this acts applies, then he gets a deduction. That is a simple illustration. Whether she actually pays any tax on it is immaterial. Whether the amount is so low that her personal exemption is adequate is immaterial. It is only that it is includible in her income if she has any.

The CHAIRMAN. I see.

Mr. O'BRIEN. The thing works in reverse, too, in those odd cases where the wife is paying alimony to the husband. I understand there are such situations.

The CHAIRMAN. So much of this bill may be regarded as a relief measure then?

Mr. O'BRIEN. Yes.

Now, page 34, line 14, begins the provision relating to the so-called nontrade and nonbusiness expenses—the *Higgins case*. All the language on pages 34 and 35, is old law, except that it needs to be reorganized on account of the change which is made at the bottom of page 35 and the top of page 36. That provides that in the case of an individual all the ordinary and necessary expenses paid or incurred during a taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, are deductible in ascertaining the net income.

The Supreme Court held in the *Higgins case* if you are not engaged in a trade or business, the expenses of an individual in, for instance, managing his securities, paying his investment counsel, and so on, are not deductible. This says they are. A similar deduction is allowed with respect to depreciation of property held for the production of income. A different rule is applied if interest, for instance, on securities would not be includible in gross income. For instance, if you hire investment counsel for the purpose of—well, take a better case: If you hire a safe deposit box to store your completely tax-exempt securities, you do not get the benefit of this deduction because the amount of income from those securities does not fall into income itself.

These series of amendments are made completely retroactive, but, Senator Brown, only to open years.

Any questions about that?

Senator TAFT. Is there an amendment for expenditures for advertising and goodwill?

Mr. O'BRIEN. That is old law, Senator.

Senator TAFT. What?

Mr. O'BRIEN. That is old law. It got in last year.

Senator TAFT. That is page 35.

Mr. O'BRIEN. Pages 34 and 35 are just a reorganization, dividing section 23 (a) into two general categories. The first is trade and

business expenses, and the second is nontrade and nonbusiness expenses.

Now, page 37, line 16, begins another important administrative change relating to bad debts. Under the present law a deduction for a bad debt is allowable only if it is ascertained to be worthless and charged off within the taxable year. This proposes to say that a deduction is allowed for a bad debt in the year in which the debt as a matter of fact became worthless, regardless of whether it was ascertained that year to be worthless, or regardless of whether it was charged off or not.

In connection with that provision I might point out that there is in here a provision to the effect that in the case of the deduction on account of a bad debt becoming worthless, the statute of limitations is 7 years rather than the 3-year statute of limitations, the reason being that it is generally so hard to ascertain just when a debt did become worthless, and it was thought desirable to have a longer period, longer statute of limitations with respect to this particular deduction.

A further change made by this section begins on page 38, line 24.

Senator CONNALLY. May I ask you right there, as I understand it the law has always been that you cannot get any deduction for gifts to individuals, but they must be given to some organization. Is that right; is that still the law?

Mr. O'BRIEN. Yes; any charitable organization, named charitable organization.

Senator CONNALLY. If some fellow comes along and touches you for $25, and you know it is a gift, you can't deduct it.

Mr. O'BRIEN. That is true.

The CHAIRMAN. You don't have to pay any gift tax on it, though.

Senator CONNALLY. No; but you are paying a gift tax when you let him have it.

Senator TAFT. Is there any change made in this particular—it is all hard to understand—that if your securities or bonds become worthless you get a 100-percent deduction, whereas if you sell them at 1 cent on the dollar, it is a loss, a capital loss, and it is a deduction for capital loss. You are limited, in other words, in your loss. There is no change?

Mr. O'BRIEN. No change.

Senator TAFT. From time to time, the Treasury suggested that that corporate securities division should be changed.

Mr. O'BRIEN. Yes.

Senator TAFT. It was changed.

Mr. PAUL. It was changed 1 or 2 years ago; 23 (k), I think it was.

Senator TAFT. That remains the way it was.

Mr. PAUL. There is no change.

Mr. O'BRIEN. The next change made by this section relates to so-called nonbusiness bad debts. Whereas, under the present law they are allowable as an ordinary loss, this proposes to treat a nonbusiness bad debt as a loss resulting from the sale or exchange during the taxable year of a capital asset held for not more than 15 months. In other words, makes them short-term losses. Instead of being deductible in full they are deductible only as a short-term capital loss. The ordinary case is where you lend a friend $100 and he doesn't pay you.

Page 40, line 16, begins the next important change, which relates

to the amortizable bond premium. It deals with the case in which a bond is purchased, let us say, for $100 and upon redemption the taxpayer gets $90, or— Well, put it the other way: The bond is purchased for $110, and on redemption the taxpayer gets $100. That $10 is bond premium. Under the present law the amount of that $10 is treated as capital loss in the year in which the bond is redeemed. This proposes in the case of such a bond, the $10 of the bond premium shall be amortized over the life, the remaining life, of the bond. In the case, let us say, of a 10-year bond, the amortization would be $1 a year for 10 years.

Senator TAFT. Are you proposing to make every individual in the country amortize his bonds?

Mr. O'BRIEN. No. In the case of a taxpayer—in the case of an individual—he can elect to have the section apply to the bonds the interest of which is partially tax exempt, the Federal Liberty bonds, and he can, if he wants to, elect to have it applied to the wholly taxable securities. As to the securities which are wholly tax exempt, it will apply automatically to him, he cannot elect it at all.

In the case of a bond the interest which is wholly or partially taxable, the amount of the amortizable bond premium for each year is allowed as a deduction and the basis of the bond is adjusted accordingly, so that when the bondholder at the end of the period redeems his bond, his basis will be down so that he has neither a capital gain or capital loss.

Senator TAFT. Is that compulsory on every bondholder?

Mr. O'BRIEN. In the case of the bonds which are wholly tax exempt it is compulsory; in the case of the bonds which are, let me say—

Senator CONNALLY. The State bonds would come under that.

Mr. O'BRIEN. In the case of a corporation and where the interest is partially taxable, or where the interest is wholly tax free, it is compulsory; in the case of an individual, where the interest is partially taxable, or where it is wholly taxable, it is elective with the individual; in the case of the wholly tax free, it is compulsory on the individual, too.

Senator TAFT. Then, last year we had this question about Government Defense bonds. Was that left optional?

Mr. O'BRIEN. That was left optional; yes.

Senator TAFT. But coupon bonds not?

Mr. O'BRIEN. They are wholly taxable now.

Senator TAFT. They are all wholly taxable?

Mr. O'BRIEN. They are all taxable now.

Senator TAFT. But an individual with a Government bond of the old type must amortize it?

Mr. O'BRIEN. If it is wholly tax free.

Senator TAFT. There aren't many of those.

Mr. O'BRIEN. No; there aren't many of those. The only important cases are the State and municipal bonds.

Senator TAFT. They must be amortized?

Mr. O'BRIEN. They must be amortized.

Senator TAFT. What is the reason for that? I mean, the ordinary taxpayer might not even keep books.

Mr. O'BRIEN. In that case the amortization is automatic.

Senator TAFT. What?

Mr. O'BRIEN. In that case the amortization is automatic.

All you do in effect is reduce the basis of the bond so that when he redeems the bond at 100 there is no loss.

Senator TAFT. Yes; but take the fellow with $10,000 in municipal bonds, say city of Cincinnati bonds, he just has his coupons, that is the only record he has—probably he has no books at all, and yet every year he has to take off or add to his income.

Mr. O'BRIEN. No; not in the case of the wholly tax free. There is an automatic reduction of the basis each year by a dollar in my example of that.

Senator TAFT. Automatic; how do you mean? No income tax is automatic. You fill it out.

Mr. O'BRIEN. No, no; he doesn't pay any tax on that interest, does he?

Senator TAFT. No.

Mr. O'BRIEN. Therefore, he doesn't include that interest in his return; therefore, he doesn't get any deduction on account of the amortization of the bond. But when the bond is redeemed by reason of the automatic operation of the amortization provision, he not having made any entry on his books whatever, the basis for determining gain or loss on the bond has been reduced from 110 to 100, so that on redemption he does not have a capital loss.

Senator TAFT. Although he paid $110 for the bond?

Mr. O'BRIEN. Although he paid $110 for the bond.

Senator TAFT. Suppose he bought the bond at 90 and then it is redeemed at maturity?

Mr. O'BRIEN. Well, there were provisions on that last year; amortized-bond discount.

Senator TAFT. What?

Mr. O'BRIEN. In the last revenue bill.

Senator TAFT. Speaking of municipal bonds, does he pay an income tax on that on the basis of buying at 90 and selling at 100; does he pay an income tax?

Mr. O'BRIEN. Yes.

Senator TAFT. He never takes a loss if he buys that bond at 110 and sells at 100.

Mr. O'BRIEN. I am not justifying it, but on the theory——

Senator TAFT. He is too well treated already.

Mr. O'BRIEN. On the theory that the interest yield on the bond is what he bargained for at 110, and he didn't bargain for a capital loss.

Senator TAFT. I see. Proceed.

Mr. O'BRIEN. And a similar provision relates to the election in the case——

Senator CONNALLY. In reverse on that, if he buys at 90, he might only make $10, but he gets the same interest rate as the other, and therefore he has a gain.

Mr. O'BRIEN. Yes; he has a gain all right.

That, in brief, is the provision about amortization. That is about all there is to that, except a lot of provisions relating to the granting of the deductions, and so forth, for amortizable bond premium to

estates and trusts and beneficiaries of estates and trusts, common trust funds, personal service corporations, and for personal holding companies.

The next provision, page 48, line 21, is an administrative change designed to close a loophole. It provides that you do not get any deduction for interest paid or accrued on indebtedness incurred or continued to purchase or carry a fully paid-up or single premium life insurance or endowment contract.

That is, you go to the bank and borrow $100,000 at 6 percent to buy a fully paid-up life-insurance policy, you don't get a deduction for the interest which you pay to the bank on account of that borrowing.

Senator CONNALLY. Does this bill do anything about the $40,000 exemption on life insurance?

Mr. O'BRIEN. Yes; it makes the combined exemption $60,000.

Page 49, line 8, allows the taxpayer to elect to treat taxes and other carrying charges as chargeable to capital account rather than deductible as current deductions. A familiar case is a man employing his own help to build a building for him, and with respect to his own help he will pay social-security taxes. This permits, under regulation by the Commission, the taxpayer to elect to include those social-security taxes as part of the cost of building rather than to deduct them this year as a deduction from current income.

Senator TAFT. Is that true of all taxes during construction; is that true generally? Must they be capitalized?

Mr. O'BRIEN. Well, taxes generally, I don't know; I think they are now; but the familiar case, of course, is where you have what is in the border line between a current running expense and something which might be attributable to a capital item, like social-security taxes on help in building a building, or like your excise tax on freight.

Senator TAFT. I was thinking of a large project, where taxes on construction are a large item and are capitalized often. Does this permit the company to capitalize or not, as it pleases?

Mr. O'BRIEN. Yes; any tax.

Senator TAFT. It may do either?

Mr. O'BRIEN. Yes.

The next change is on page 50, line 1, which relates to the personal exemption of single people and married people. With single people it is reduced from $750 to $500, and married people from $1,500 to $1,200.

Senator VANDENBERG. Now, at that point, I would like those figures, if they are available. How many additional income-tax payers does that reduced exemption produce?

Mr. O'DONNELL. We estimate that the returns that are made taxable by the reduction of the exemptions will number 6,998,000; approximately 7,000,000 returns.

Senator VANDENBERG. You mean that that is an increase of 7,000,000 taxable returns?

Mr. O'DONNELL. That is right.

Senator VANDENBERG. And how much taxes do you collect from that 7,000,000 as a result of that?

Mr. O'DONNELL. We estimate there that we will get $109,500,000 from those persons made taxable by the reduction in exemptions.

Senator VANDENBERG. And how much do you get from the balance of the tax structure as the result of reducing the exemption?

Mr. PAUL. Approximately $1,100,000,000.

Senator VANDENBERG. In other words, the reduction of the exemption is 10 times as hard on those who paid taxes before as it is on those who become new taxpayers?

Mr. PAUL. It is true that 10 times as much tax on the amount by which the exemption is lowered comes from those that have already been paying taxes as compared with new taxpayers; that is true.

Senator GERRY. In that connection, I would like to ask a question that I asked this morning in regard to the 1941 estimate. The 1941 tax returns, haven't you got enough tax returns in now, the March returns, or possibly the June returns, to see how accurate those estimates were?

Mr. PAUL. You are talking about the 1941 estimates?

Senator GERRY. Yes.

Mr. PAUL. I don't think I quite understood you this morning.

Senator GERRY. I don't think you did either.

Mr. PAUL. I thought you meant the '42.

Senator GERRY. No.

Mr. PAUL. I think perhaps Mr. O'Donnell should answer that question.

Mr. O'DONNELL. Senator Gerry, let me answer it this way: The individual income-tax Budget estimates made for the President last December were sufficiently accurate so that we changed the estimates very little in the April Budget revision. The actual receipts showed that these estimates were substantially correct.

Senator GERRY. I don't think that quite answers my question. I mean they estimated the 1941 bill would bring in this year so much revenue.

Mr. O'DONNELL. Yes.

Senator GERRY. Now, is it bringing in more or less?

Mr. O'DONNELL. Well, that is a difficult question to answer, because the provisions of the bill after it has been passed affect the actions that are taken by taxpayers with reference to components of income that they receive.

Senator GERRY. Yes.

Mr. O'DONNELL. But I would say this in general without being specific. When we met a year ago we did not anticipate the kind of expenditures that the Government has made since. No one realized the rate at which the economy would have to be converted to the war effort. The result is that the national income and all incomes are higher than we thought at that time they would be. Unquestionably provisions which became an integral part of the income-tax law yielded somewhat more money than we would have a year ago anticipated.

Senator GERRY. Well, what you are saying is that these circumstances have changed.

Mr. O'DONNELL. That is why we have to revise Budget estimates.

Senator GERRY. But the estimates of last year were lower than what the 1941 bill has shown, as far as you can tell from your March returns and your June returns. Now, there were certain of us in the committee that thought that was going to be the case, apart even from the war effort. That is neither here nor there, but I am just trying to see how accurate your estimates were.

Mr. O'DONNELL. I think you are quite right, Senator Gerry. The accentuated industrial activity and augmented incomes which have

come about in large measure by virtue of the extension of the Government expenditures and the conversion to the war effort have resulted in larger incomes and larger taxes than we expected a year ago. I think that the end result is in the direction you state.

Senator GERRY. Pretty largely.

Mr. O'DONNELL. With reference to excise taxes, it worked in the other direction, because of the necessity to convert civilian economy to the war effort. Priorities, allocations, and rationing were used to a greater extent than we had anticipated and production of goods for civilian use were greatly curtailed and will be curtailed still further. The result is that some of the excise taxes won't yield in a full year of operation in the future as much as we expected a year ago that they would yield.

Senator GERRY. The net result is what I am interested in. That answers my question.

Mr. PAUL. Very frankly, we were just a little low.

Mr. O'DONNELL. I think that is true.

Senator VANDENBERG. Mr. O'Donnell, while you still have your figures before you, can you tell me how much you expect to get out of this bill from persons with incomes of $3,000 and under.

Mr. O'DONNELL. Yes, sir; I think so. I will have to add some figures together, or perhaps you can do it for me.

From individual taxpayers with net incomes of under $1,000 we expect—and this includes new and old returns—$103,000,000.

Senator VANDENBERG. Yes.

Mr. O'DONNELL. From individual taxpayers having net incomes of $1,000 to $2,000, we expect $1,103,000,000; from individual taxpayers having net incomes of $2,000 to $3,000, we expect $1,050,000,000.

Senator VANDENBERG. Do you mean you will get $2,250,000,000 from incomes of $3,000 and less?

Mr. O'DONNELL. That is right. I will insert in the record a table (exhibit A) giving this information by certain net income classes, both under the bill and under present law.

(The table referred to is as follows:)

EXHIBIT A.—*Estimated number of returns, net income, and tax, by net-income classes, at levels of income estimated for calendar year 1942, under present law and under the revenue bill of 1942 (H. R. 7378) as passed by the House of Representatives, July 20, 1942*[1]

[Money amounts in millions of dollars; number of returns in thousands]

Net-income classes	Number of returns		Net income		Tax	
	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942
	Returns made taxable by reduction in exemptions					
Under $1,000	.....	1,764	.....	1,047	.....	24.5
$1,000 to $2,000	.....	4,882	.....	6,859	.....	80.8
$2,000 to $3,000	.....	334	.....	703	.....	3.9
$3,000 to $4,000	.....	16	.....	55	.....	.3
$4,000 to $5,000	.....	2	.....	8	.....	(2)
Total under $5,000	.....	6,998	.....	8,733	.....	109.5
$5,000 to $10,000	.....	.....	.....	.....	.....	.....
Over $10,000	.....	.....	.....	.....	.....	.....
Total	.....	6,998	.....	8,733	.....	109.5

EXHIBIT A.—*Estimated number of returns, net income, and tax, by net-income classes, at levels of income estimated for calendar year 1942 under present law and under the Revenue Bill of 1942 (H. R. 7378) as passed by the House of Representatives July 20, 1942*—Continued

Net-income classes	Number of returns		Net income		Tax	
	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942
	Returns taxable under present law exemptions					
Under $1,000	2,493	2,493	1,984	1,650	15.7	78.3
$1,000 to $2,000	7,705	7,705	12,224	12,048	304.5	1,021.8
$2,000 to $3,000	5,697	5,697	13,826	13,564	434.4	1,045.9
$3,000 to $4,000	1,877	1,877	6,510	6,393	279.7	579.2
$4,000 to $5,000	804	804	3,507	3,509	221.2	442.4
Total under $5,000	18,636	18,636	38,111	37,169	1,255.5	3,167.6
$5,000 to $10,000	881	881	5,879	5,751	538.3	946.6
Over $10,000	385	385	9,461	8,767	3,250.7	3,693.4
Total	19,902	19,902	53,451	51,687	5,044.8	7,807.6
	All returns taxable under proposed reduced exemptions					
Under $1,000	2,493	4,257	1,984	2,697	15.7	102.8
$1,000 to $2,000	7,705	12,647	12,224	18,907	304.5	1,102.6
$2,000 to $3,000	5,697	6,031	13,826	14,327	434.4	1,049.8
$3,000 to $4,000	1,877	1,893	6,510	6,453	279.7	579.5
$4,000 to $5,000	804	806	3,507	3,517	221.2	442.4
Total under $5,000	18,636	25,634	38,111	45,902	1,255.5	3,277.1
$5,000 to $10,000	881	881	5,879	5,751	538.3	946.6
Over $10,000	385	385	9,461	8,767	3,250.7	3,693.4
Total	19,902	26,900	53,451	60,420	5,044 8	7,917.1

[1] Increased surtax rate schedule and adopted 6-percent normal tax; changed treatment of capital gains and losses; and lowered personal exemptions to $1,200 for a married couple or the head of a family, and to $500 for a single person, or a married person not living with husband or wife.
[2] Less than $0.05 million.

NOTE.—Figures are rounded and will not necessarily add to totals.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Senator VANDENBERG. And what do you get out of the total bill, for everybody, in income taxes? What is your grand total?

Mr. O'DONNELL. We estimate that the individual income tax liabilities, at estimated calendar year 1942 levels of incomes will total $7,917,000,000.

Senator BROWN. That is this bill?

Mr. O'DONNELL. That is the total yield of the individual income tax provisions of this bill. It is not an additional yield over the yield of the existing law. What Senator Vanderberg asked for was the amount of taxes to be paid in the aggregate by persons paying an individual income tax.

Senator BROWN. Under this bill.

Senator CLARK. You mean the total income from personal income tax is $8,000,000,000.

Mr. O'DONNELL. $7,917,000,000.

Senator CLARK. Out of which $2,250,000,000 is from net incomes of $3 000 and less?

Mr. O'DONNELL. Yes, sir.

Senator VANDENBERG. I thought the whole bill was only between $6,000,000,000 and $7,000,000,000.

Mr. O'DONNELL. That is correct, but that is in addition to the present law yield from all taxes. I will insert in the record at this point a table showing the increase in each of the taxes included in the bill over the yield of the present law.

(The table referred to is as follows:)

EXHIBIT B.—*Summary of revenue effect of the revenue bill of 1942 as passed by House of Representatives, July 20, 1942*

[In millions of dollars]

	Increase (+), decrease (−) over yield of present law		Increase (+), decrease (−) over yield of present law
Income and excess-profits taxes:		Manufacturers' excise taxes:	
Corporation:		Lubricating oil	+13.9
Income	+383.4	Photographic apparatus	+7.6
Excess profits	+2,315.8	Rubber articles	−8.9
Declared value excess-profits tax	−58.5	Electric signs	−.1
Total corporation income and excess-profits taxes	+2,640.7	Washing machines	−.1
Individual income tax	+2,872.3	Optical equipment	−.3
Total income and excess-profits taxes	+5,513.0	Total manufacturers' excise taxes	+12.1
Miscellaneous internal revenue:		Miscellaneous taxes:	
Capital stock tax	−51.5	Telephone, telegraph, radio and cable facilities, leased wires, etc.	+26.8
Estate tax	−14.8	Telephone bill	+36.8
Gift tax	+7.7	Transportation of persons	+33.0
Total	−58.6	Coin-operated amusement and gaming devices	+4.4
Liquor taxes:		Transportation of property	+252.9
Distilled spirits [1]	+266.1	Pari-mutuel wagers	+23.6
Fermented malt liquors [1]	+61.8	Total miscellaneous taxes	+378.4
Wines [1]	+11.6	Total miscellaneous internal revenue	+758.2
Total liquor taxes	+339.5	Total internal revenue	+6,271.2
Tobacco taxes:			
Cigarettes [1]	+51.4		
Tobacco, smoking	+11.8		
Cigars (large)	+15.8		
Cigarette papers and tubes	+7.8		
Total tobacco taxes	+86.8		

[1] Excluding nonrecurring floor-stocks taxes which are estimated to yield: Distilled spirits, $80.0 millions; fermented malt liquors, $2.0 millions; wines, $2.3 millions; cigarettes, $5.8 millions; smoking tobacco, $1.4 millions; cigars (large), $1.6 millions.

NOTE.—All estimates show full year effect assuming all proposed changes were fully reflected in revenue for an entire year. Estimates of income and excess-profits taxes and the gift tax are at levels of income estimated for calendar year 1942. All other estimates are at levels of income estimated for fiscal year 1943.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Mr. O'DONNELL. Under the present law we estimate the calendar year 1942 individual income-tax liabilities at $5,045,000,000. The difference between $5,045,000,000 and the $7,917,000,000 estimated calendar year 1942 income-tax liabilities under this bill represents the increment of $2,872,000,000 in individual income taxes attributed to the bill. The distribution of this increased individual income-tax yield over the yield of the present law is shown in the following table.

(The table referred to is as follows:)

EXHIBIT C.—*Estimated tax liabilities and percentage distribution by net income classes, at levels of income estimated for calendar year 1942, under present law and under the revenue bill of 1942 (H. R. 7378) as passed by the House of Representatives, July 20, 1942* [1]

[Money amounts in millions of dollars]

Net-income classes	Total tax liabilities				Increase over yield of present law	
	Amount		Percentage distribution			
	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Amount	Percentage distribution
	Returns made taxable by reduction in exemptions					
Under $1,000	.....	24.5	.....	22.4	24.5	22.4
$1,000 to $2,000	.....	80.8	.....	73.7	80.8	73.7
$2,000 to $3,000	.....	3.9	.....	3.6	3.9	3.6
$3,000 to $4,000	.....	.3	.....	.3	.3	.3
$4,000 to $5,000	.....	(2)	.....	.....	(2)	.....
Total under $5,000	.....	109.5	.....	100.0	109.5	100.0
$5,000 to $10,000	.....	.....	.....	.....	.....	.....
Over $10,000	.....	.....	.....	.....	.....	.....
Total	.....	109.5	.....	100.0	109.5	100.0
	Returns taxable under present law exemptions					
Under $1,000	15.7	78.3	0.3	1.0	62.6	2.3
$1,000 to $2,000	304.5	1,021.8	6.0	13.1	717.3	26.0
$2,000 to $3,000	434.4	1,045.0	8.6	13.4	611.5	22.1
$3,000 to $4,000	279.7	579.2	5.6	7.4	299.5	10.8
$4,000 to $5,000	221.2	442.4	4.4	5.7	221.2	8.0
Total under $5,000	1,255.5	3,167.6	24.9	40.6	1,912.1	69.2
$5,000 to $10,000	538.3	946.6	10.7	12.1	408.3	14.8
Over $10,000	3,250.7	3,693.4	64.4	47.3	442.7	16.0
Total	5,044.8	7,807.6	100.0	100.0	2,762.8	100.0
	All returns taxable under proposed reduced exemptions					
Under $1,000	15.7	102.8	0.3	1.3	87.1	3.0
$1,000 to $2,000	304.5	1,102.6	6.0	13.9	798.1	27.8
$2,000 to $3,000	434.4	1,049.8	8.6	13.3	615.4	21.4
$3,000 to $4,000	279.7	579.5	5.6	7.3	299.8	10.5
$4,000 to $5,000	221.2	442.4	4.4	5.6	221.2	7.7
Total under $5,000	1,255.5	3,277.1	24.9	41.4	2,021.6	70.4
$5,000 to $10,000	538.3	946.6	10.7	12.0	408.3	14.2
Over $10,000	3,250.7	3,693.4	64.4	46.6	442.7	15.4
Total	5,044.8	7,917.1	100.0	100.0	2,872.3	100.0

[1] Increased surtax rate schedule and adopted 6 percent normal tax; changed treatment of capital gains and losses; and lowered personal exemptions to $1,200 for a married couple or the head of a family, and to $500 for a single person, or a married person not living with husband or wife.

[2] Less than $0.05 million.

NOTE.—Figures are rounded and will not necessarily add to totals.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Senator BARKLEY. In other words, on the subject of income taxes, the bill is rewritten. In other words, it is as if there had been no law. You write it all over again, and it gets from the taxes levied $7,900,000,000.

Mr. O'DONNELL. That is correct, Senator Barkley. I have a table which gives this information for all of the income taxes and will insert it in the record at this point. The table advisedly contains not only the estimates of the individual income tax yield but also the estimates of the corporate tax yield. It is necessary that these estimates be presented together because variations in the corporation taxes have a direct effect upon the yield of the individual income taxes. As corporate taxes become larger, corporations are less able to pay dividends and the result is a smaller amount of dividends received by taxpayers with the consequent diminution in the tax yield from any given schedule of income taxes.

I think that I should point out in passing that when we compare the individual income tax yield of H. R. 7378 with the yield of the individual income taxes contained in the present law we do not fully measure the amount by which the individual income tax law has been strengthened. In other words, because of the increased corporation taxes contained in H. R. 7378, the present individual income tax law would yield less money than it will yield under the corporation taxes contained in the present law. Consequently, the income tax provisions in H. R. 7378 have to make up the loss in revenue caused by the diminution in dividends before we begin to measure the increased yield over the yield of the present law.

(The table referred to is as follows:)

EXHIBIT D.—*Income and excess-profits taxes—estimated revenue effect, at levels of income estimated for the calendar year 1942, of the revenue bill of 1942 (H. R. 7378) as passed by House of Representatives, July 20, 1942*

[In millions of dollars]

	Estimated liabilities under present law	Increase (+), decrease (−), due to revenue bill of 1942	Total income tax yield, revenue bill of 1942
Corporation income and excess-profits taxes:			
Income tax (current)	3,941.9	+383.4	4,325.3
Excess-profits tax	3,597.7	+2,315.8	5,913.5
Declared value excess-profits tax	107.5	−58.5	49.0
Total corporation income and excess-profits taxes	7,647.1	+2,640.7	10,287.8
Individual income tax (current)	5,044.8	+2,872.3	7,917.1
Total	12,691.9	+5,513.0	18,204.9
Back taxes:			
Income	400.0	.....	400.0
Unjust enrichment	4.0	.....	4.0
Total back income taxes	404.0	.....	404.0
Total income and excess-profits taxes	13,095.9	+5,513.0	18,608.9

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Senator BARKLEY. So that if you take the whole field of taxation, based on that analogy, how much will this bill get in total revenue?

Mr. O'Donnell. I appreciate that it is difficult to follow statistics presented orally. If you wish I can insert in the record a table which, when studied in conjunction with the income-tax yield table just inserted in the record, will be helpful in answering the question which you have asked. A categorical answer to the question without a detailed technical explanation would be subject to misunderstanding.

The Chairman. We will be glad to have it in the record.

(The table referred to is as follows:)

Exhibit E.—*Miscellaneous internal revenue—Estimated fiscal year 1943 receipts under present law and estimated full-year effect of the revenue bill of 1942 (H. R. 7378) as passed by the House of Representatives July 20, 1942, at levels of income estimated for fiscal year 1943*

[In thousands of dollars]

	Estimated receipts under present law	Estimated increase or decrease (−) due to revenue bill of 1942 [1]	Estimated total receipts, present law plus revenue bill of 1942 [1]
Miscellaneous internal revenue:			
Capital stock tax	$290,000	−$51,500	$238,500
Estate tax	500,000	−14,800	485,200
Gift tax	30,700	7,700	38,400
Liquor taxes:			
Distilled spirits (domestic and imported) (excise tax)	710,000	266,100	976,100
Fermented malt liquors	386,700	61,800	448,500
Rectification tax	6,800		6,800
Wines (domestic and imported) (excise tax)	35,600	11,600	47,200
Special taxes in connection with liquor occupations	11,600		11,600
Container stamps	11,700		11,700
Floor stocks taxes	5,300		5,300
All other	1,400		1,400
Total liquor taxes [2]	1,169,100	339,500	1,508,600
Tobacco taxes:			
Cigarettes	761,800	51,400	813,200
Tobacco (chewing and smoking)	53,000	11,800	64,800
Cigars (large)	14,700	15,800	30,500
Snuff	7,500		7,500
Cigarette papers and tubes	1,800	7,800	9,600
All other	142		142
Total tobacco taxes [2]	838,942	86,800	925,742
Stamp taxes:			
Issues of securities, bond transfers, and deeds of conveyance	23,800		23,800
Stock transfers	12,800		12,800
Playing cards	5,400		5,400
Silver bullion sales or transfers	25		25
Total stamp taxes	42,025		42,025
Manufacturers' excise taxes:			
Gasoline	242,100		242,100
Lubricating oils	42,500	13,900	56,400
Passenger automobiles and motorcycles	3,000		3,000
Automobile trucks, busses, and trailers	4,000		4,000
Parts and accessories for automobiles	8,000		8,000
Tires and inner tubes	8,000		8,000
Rubber articles	8,900	−8,000	
Electrical energy	51,400		51,400
Electric, gas, and oil appliances	1,500		1,500
Electric light bulbs	3,400		3,400
Electric signs	50	−50	
Radio receiving sets, phonographs, phonograph records, and musical instruments	6,100		6,100
Refrigerators, refrigerating apparatus, and air conditioners	4,300		4,300
Washing machines	50	−50	
Business and store machines	2,500		2,500

See footnotes at end of table.

EXHIBIT E.—*Miscellaneous internal revenue—Estimated fiscal year 1943 receipts under present law and estimated full-year effect of the revenue bill of 1942 (H. R. 7378) as passed by the House of Representatives July 20, 1942, at levels of income estimated for fiscal year 1943*—Continued

[In thousands of dollars]

	Estimated receipts under present law	Estimated increase or decrease (−) due to revenue bill of 1942	Estimated total receipts, present law plus revenue bill of 1942
Manufacturers' excise taxes—Continued.			
Photographic apparatus	$7,200	$7,600	$14,800
Optical equipment	300	−300	
Matches	6,200		6,200
Luggage	4,000		4,000
Sporting goods	2,400		2,400
Firearms, shells, pistols, and revolvers	2,000		2,000
Total manufacturers' excise taxes	407,900	12,200	420,100
Retailers' excise taxes:			
Jewelry, etc	54,000		54,000
Furs	46,300		46,300
Toilet preparations	28,000		28,000
Total retailers' excise taxes	128,300		128,300
Miscellaneous taxes:			
Telephone, telegraph, radio and cable facilities, leased wires, etc	52,800	26,800	79,600
Telephone bill	55,200	36,800	92,000
Transportation of oil by pipe line	14,800		14,800
Transportation of persons	34,000	33,000	67,000
Admissions	143,000		143,000
Club dues and initiation fees	7,200		7,200
Leases of safe-deposit boxes	4,200		4,200
Use of motor vehicles and boats	149,200		149,200
Coconut and other vegetable oils processed	2,400		2,400
Oleomargarine, etc., including special taxes and adulterated butter	2,500		2,500
Bituminous-coal tax	5,500		5,500
Sugar tax	49,900		49,900
Coin-operated amusement and gaming devices	6,200	4,400	10,600
Bowling alleys and billiard and pool tables	2,000		2,000
Transportation of property		252,900	252,900
Pari-mutuel wagering		23,600	23,600
All other, including repealed taxes	800		800
Total miscellaneous taxes	530,300	378,400	908,700
Total miscellaneous internal revenue (collection basis)	3,937,267	758,300	4,695,567

[1] Assuming that all provisions of the law were fully reflected in receipts for an entire year.
[2] Excluding nonrecurring collections of floor-stock taxes: Liquor taxes, $91.3 millions; tobacco taxes, $8.8 millions.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Senator VANDENBERG. As I understand it, you get, in round numbers, about $3,000,000,000 increased individual income-tax revenues from this bill as it now stands; is that right?

Mr. O'DONNELL. That is $2,872,300,000, to give you the exact figure.

Senator VANDENBERG. All right. Now, can you tell me how much of that two billion eight comes from net incomes under $3,000?

Mr. O'DONNELL. The total yield from these taxpayers is the figure which you and I totaled together, $2,256,000,000. Under the present law it is estimated that taxpayers in these same net income classes will have income-tax liabilities of $16,000,000 for the group with net incomes under $1,000; $305,000,000 for the group with net incomes of $1,000 to $2,000 and $434,000,000 for the group with net incomes of from $2,000 to $3,000.

Senator VANDENBERG. That is $755,000,000.

Mr. O'DONNELL. Yes, sir; and if you will subtract it from the $2,256,000,000 for which they would be liable under the proposed legislation we see that the group with net incomes of less than $3,000 have their taxes increased $1,501,000,000 by the bill.

Senator VANDENBERG. About one and a half billions out of the $2,872,000,000 comes from this group.

Mr. O'DONNELL. Yes, sir. A table which shows this tax liability cumulated by net income classes can be inserted in the record for your convenience.

Senator TAFT. Could you insert also the number of returns?

Mr. O'DONNELL. Yes, sir; I shall be glad to do that.

Senator BARKLEY. Will you indicate, if you have the figures on it, the total net income under this bill—what it would be—which includes all that has heretofore been levied and what is added by this bill?

Mr. O'DONNELL. Yes, sir. In the table which I shall label "Exhibit F" for the record, you will find a comparison by net income classes not only of the tax due under present law with that due under the revenue bill of 1942, but also comparable figures for the number of returns and for the net income, likewise classified by net income classes.

This table, which also shows the cumulated figures for the specified net income classes, enables us to study the percentage distribution of the number of returns, the net income, and the tax liability under existing law and under the revenue bill of 1942, so that the shifting in the relative importance of each net income class with reference to the contribution which the taxpayers in each class makes to the total income tax liability may be ascertained.

The table shows that in the higher net income classes such a large percentage of the net incomes is already taken in taxes and such a relatively small absolute amount of net income remains that any substantial increase in income taxes must result in a downward shift in the relative income tax burden by net income classes.

From the table showing the simple distribution of the tax by net income classes it is clear that for each class shown, up through the class with net incomes from $5,000 to $10,000, the percentage of the total tax burden which each class bears has been increased under the revenue bill of 1942 as compared with the present law and for each class with net incomes in excess of $10,000, the relative percentage of the total burden has been decreased. The absolute amount of tax liability has been increased in each net income class. However, in the column of the table showing the cumulative distribution of the tax liability it is clearly shown that the relative percentage of the total burden has been shifted downward by the revenue bill of 1942 as compared with the present law.

For the purposes of illustration, take the group that Senator Vandenberg was discussing with net incomes of less than $3,000. These taxpayers, with respect to the total individual income tax liability on calendar year 1942 incomes, will be liable for $755,000,000, or 15.0 percent, of the total individual income tax liability under the present law, whereas their $2,256,000,000 liability will represent 28½ percent of the total individual income tax liabilities under the revenue bill of 1942.

(The table referred to is as follows:)

EXHIBIT F.—*Estimated number of returns, net income, and tax under the present law and the revenue bill of 1942 (H. R. 7378) as passed by the House of Representatives July 20, 1942, at net income levels estimated for calendar year 1942, distributed by net income classes*

[Money amounts in millions of dollars; number of returns in thousands]

Net income class (in thousands of dollars)	Simple distribution				Cumulative distribution from lowest income class				Cumulative distribution from highest income class			
	Amount		Percent		Amount		Percent		Amount		Percent	
	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law	Revenue bill of 1942	Present law
	Number of returns											
Under 1	4,257	2,493	15.8	12.5	4,257	2,493	15.8	12.5	26,900	19,902	100.0	100.0
1 to 2	12,647	7,765	47.0	39.0	16,904	10,258	62.8	51.5	22,643	17,410	84.2	87.5
2 to 3	6,031	5,697	22.4	28.6	22,935	15,955	84.2	80.2	9,996	9,644	37.2	48.5
3 to 4	1,893	1,877	7.1	9.4	24,828	17,832	92.3	89.6	3,965	3,947	14.8	19.8
4 to 5	806	804	3.0	4.0	25,634	18,637	95.3	93.6	2,072	2,070	7.7	10.4
5 to 10	881	881	3.3	4.4	26,516	19,518	98.6	98.1	1,266	1,266	4.7	6.4
10 to 25	300	300	1.1	1.5	26,815	19,818	99.7	99.6	385	385	1.4	1.9
25 to 100	76	76	.3	.4	26,891	19,893	100.0	100.0	85	85	.3	.4
Over 100	9	9	(1)	(1)	26,900	19,902	100.0	100.0	9	9	(1)	(1)
Total	26,900	19,902	100.0	100.0								
	Net income											
Under 1	$2,697	$1,984	4.5	3.7	$2,697	$1,984	4.5	3.7	$60,420	$53,451	100.0	100.0
1 to 2	18,907	12,224	31.3	22.9	21,604	14,207	35.8	26.6	57,723	51,468	95.5	96.3
2 to 3	14,327	13,826	23.7	25.9	35,931	28,034	59.5	52.5	38,816	39,244	64.2	73.4
3 to 4	6,453	6,510	10.7	12.2	42,384	34,543	70.2	64.6	24,489	25,418	40.5	47.6
4 to 5	3,517	3,567	5.8	6.7	45,901	38,110	76.0	71.3	18,036	18,908	29.8	35.4
5 to 10	5,752	5,879	9.5	11.0	51,653	43,989	85.5	82.3	14,519	15,341	24.0	28.7
10 to 25	4,175	4,374	6.9	8.2	55,828	48,363	92.4	90.5	8,767	9,462	14.5	17.7
25 to 100	2,886	3,119	4.8	5.8	58,714	51,483	97.2	96.3	4,592	5,088	7.6	9.5
Over 100	1,706	1,968	2.8	3.7	60,420	53,451	100.0	100.0	1,706	1,968	2.8	3.7
Total	60,420	53,451	100.0	100.0								

	Tax											
Under 1	$103	$16	1.3	0.3	$103	$16	1.3	0.3	$7,917	$5,045	100.0	100.0
1 to 2	1,103	305	13.9	6.0	1,206	320	15.2	6.4	7,814	5,029	98.7	99.7
2 to 3	1,050	434	13.3	8.6	2,256	755	28.5	15.0	6,711	4,725	84.8	93.7
3 to 4	579	280	7.3	5.6	2,835	1,034	35.8	20.5	5,661	4,290	71.5	85.0
4 to 5	442	221	5.6	4.4	3,277	1,256	41.4	24.9	5,082	4,010	64.2	79.5
5 to 10	947	538	12.0	10.7	4,224	1,794	53.4	35.6	4,640	3,789	58.6	75.1
10 to 25	1,106	810	14.0	16.1	5,330	2,605	67.4	51.6	3,693	3,251	46.6	64.4
25 to 100	1,337	1,196	16.8	23.7	6,667	3,801	84.2	75.3	2,587	2,440	32.6	48.4
Over 100	1,250	1,244	15.8	24.7	7,917	5,045	100.0	100.0	1,250	1,244	15.8	24.7
Total	7,917	5,045	100.0	100.0								

[1] Less than 0.05 percent.

NOTE.—Figures are rounded and will not necessarily add to totals.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Senator BARKLEY. You don't know now, in one lump sum, how much it will raise?

Mr. O'DONNELL. The reason I did not immediately state a figure was because I did not want to get into a technical discussion. Because of the difference in the effective dates of the amendments made by the revenue bill, it is impossible to make an over-all estimate of the revenue effect of all the changes at the same levels of income. It is our practice to prepare estimates of the revenue effect of a tax bill by adding together the yield of each provision of the bill for the first year in which each of the provisions is effective. We assume that each provision could be fully effective for some period for which we have been required to make forecasts of business and income levels in making the official Budget estimates of the revenues of the United States Government. Our experience is that this is the most practical way to estimate the yield of the bill since some of the provisions of this bill will not become fully effective until 1948 and it is obviously impossible to forecast that far ahead. Therefore, our estimates of the effect of the income-tax revision are based on levels of income estimated for calendar year 1942, while estimates of the excise taxes are based in general on levels of income estimated for the fiscal year 1943.

Senator BARKLEY. I mean the whole amount the Treasury will get out of the tax law when this bill is written.

Mr. O'DONNELL. Under the present law, we estimate that we will get nearly $17,000,000,000 in the fiscal year 1943.

The CHAIRMAN. Is that exclusive of the social security?

Mr. O'DONNELL. That is after the net appropriation for Federal old-age and survivors insurance trust fund.

The CHAIRMAN. $17,000,000,000?

Mr. O'DONNELL. The best way to explain what this bill adds is to say that the bill in a full year of operation will add $6,271,200,000. That will, however, not all be received in the fiscal year 1943.

The CHAIRMAN. About how much of that will be?

Mr. O'DONNELL. A little over $4,000,000,000, depending on the effective date of the new law.

The CHAIRMAN. So you would add four billion to seventeen billion?

Mr. O'DONNELL. That is correct.

Senator BARKLEY. That is what I was trying to get at.

Mr. O'DONNELL. Approximately $21,000,000,000 for the fiscal year 1943.

Senator BARKLEY. The total annual revenue the Treasury will receive from this law.

Mr. O'DONNELL. The bill will add $6,271,200,000.

Senator BARKLEY. I am not talking about this particular bill. I mean the total under the law as it will be.

Mr. O'DONNELL. As I noted before, as the period upon which estimates of the revenue bill of 1942 are based varies for the several taxes affected, it is impossible to combine the estimated increase in yield of $6,300,000,000 with present law receipts for any specific period. Although neither method is correct, the total yield of the bill might be expressed in two ways. The simpler would be to add the full year effect of the bill, $6,300,000,000 to estimated receipts in fiscal year 1943 under the present law, which amount to $16,900,000,000. This total would be $23,200,000,000. This would not, however, be the maximum figure for the period for which we have forecast incomes and revenues

as it would not fully reflect the changes in the income-tax law. A better method would be to take the total income-tax liabilities under the bill for calendar year 1942 and combine it with estimated receipts under the bill for a full year of operations at fiscal year 1943 estimated levels of incomes and business for all other tax sources. Under this method, the total annual revenue from the bill amounts to $24,200,000,000.

Senator BARKLEY. I am trying to get the figure for any given year based upon your estimate.

The CHAIRMAN. In a full year of operation.

Mr. O'DONNELL. I am inclined to use the total of $24,200,000,000. Let us say that is a hypothetical figure, because it does not apply to a particular year.

The CHAIRMAN. That is exclusive of social security.

Mr. O'DONNELL. It is after the net appropriation for the Federal old-age and survivors insurance trust fund. The laws, including the provisions of this bill, may yield in any specific year very much less or very much more than this amount, depending upon the levels of business and incomes.

The CHAIRMAN. You estimate that about $4,000,000,000 only will be produced during this present fiscal year. You get only a part of your excise taxes and gift taxes.

Mr. O'DONNELL. When I say $4,000,000,000, I assume that this bill will be passed in time for its excise-tax provisions to become effective October 1.

The CHAIRMAN. At least get that one quarter in 1942.

Mr. O'DONNELL. Yes, sir. And then we will get two quarters of the income-tax installment payments of the calendar year 1942 income-tax liabilities plus one quarter's collections of the withholding tax. I have a table (exhibit G) showing these data in detail which I shall offer for the record at this point.

(The table referred to is as follows:)

EXHIBIT G.—*Estimated Federal revenue for the fiscal year 1943, assuming enactment effective Oct. 1, 1942, of the revenue bill of 1942 (H. R. 7378) as passed by House of Representatives July 20, 1942*

[In millions of dollars]

General and special accounts	Estimated receipts, present law (April 1942 revision)	Increase or decrease (−) due to revenue bill of 1942	Estimated receipts, present law plus revenue bill of 1942
1. Internal revenue:			
(1) Income taxes:			
Corporation:			
Normal and surtax, current [1]	3,678.0	226.0	3,904.0
Excess-profits tax	3,245.0	1,166.0	4,411.0
Declared value excess-profits tax	80.0	−22.0	58.0
Total corporation	7,003.0	1,370.0	8,373.0
Individual, current [1]	4,624.0	2,216.0	6,840.0
Back taxes:			
Corporation (normal and surtax) and individual	400.0		400.0
Unjust enrichment tax	4.0		4.0
Total back taxes	404.0		404.0
Total income taxes (collection basis)	12,031.0	3,586.0	15,617.0
Adjustment to daily Treasury statement basis			
Total income taxes (daily Treasury statement basis)	12,031.0	3,586.0	15,617.0

See footnotes at end of table.

EXHIBIT G.—*Estimated Federal revenue for the fiscal year 1943, assuming enactment effective Oct. 1, 1942, of the revenue bill of 1942 (H. R. 7378) as passed by House of Representatives July 20, 1942*—Continued

[In millions of dollars]

General and special accounts	Estimated receipts, present law (April 1942 revision)	Increase or decrease (−) due to revenue bill of 1942	Estimated receipts, present law plus revenue bill of 1942
I. Internal revenue—Continued.			
(2) Miscellaneous internal revenue:			
Capital-stock tax	290.0	−51.5	238.5
Estate tax	500.0		500.0
Gift tax	30.7		30.7
Liquor taxes:			
Distilled spirits (domestic and imported) (excise tax)[1]	[2] 710.0	201.0	911.0
Fermented malt liquors [1]	386.7	42.6	429.3
Rectification tax [1]	6.8		6.8
Wines (domestic and imported) (excise tax)[1]	35.6	9.3	44.9
Special taxes in connection with liquor occupations	11.6		11.6
Container stamps	11.7		11.7
Floor stocks taxes	5.3	84.7	90.0
All other	1.4		1.4
Total liquor taxes	1,169.1	337.6	1,506.7
Tobacco taxes:			
Cigarettes [1]	761.8	38.1	799.9
Tobacco (chewing)[1]	17.5		17.5
Tobacco (smoking)[1]	35.5	8.7	44.2
Cigars (large)[1]	14.7	11.7	26.4
Snuff	7.5		7.5
Cigarette papers and tubes	1.8	7.2	9.0
Floor stocks taxes		8.8	8.8
All other [1]	.1		.1
Total tobacco taxes	838.9	74.5	913.4
Stamp taxes:			
Issues of securities, bond transfers, and deeds of conveyance	23.8		23.8
Stock transfers	12.8		12.8
Playing cards [1]	5.4		5.4
Silver bullion sales or transfers			
Total stamp taxes	42.0		42.0
Manufacturers' excise taxes:			
Gasoline	242.1		242.1
Lubricating oils	42.5	9.1	51.6
Passenger automobiles and motorcycles	3.0		3.0
Automobile trucks, busses, and trailers	4.0		4.0
Parts and accessories for automobiles	8.0		8.0
Tires and inner tubes	8.0		8.0
Rubber articles	8.9	−5.9	3.0
Electrical energy	51.4		51.4
Electric, gas, and oil appliances	1.5		1.5
Electric light bulbs	3.4		3.4
Electric signs	.1	−.1	
Radio receiving sets, phonographs, phonograph records, and musical instruments	6.1		6.1
Refrigerators, refrigerating apparatus, and air-conditioners	4.3		4.3
Washing machines	.1	−.1	
Business and store machines	2.5		2.5
Photographic apparatus	[2] 7.2	4.0	11.2
Optical equipment	.3	−.2	.1
Matches	6.2		6.2
Luggage	4.0		4.0
Sporting goods	2.4		2.4
Firearms, shells, pistols, and revolvers	2.0		2.0
Total manufacturers' excise taxes	408.0	6.8	414.8

See footnotes at end of table.

EXHIBIT G.—*Estimated Federal revenue for the fiscal year 1943, assuming enactment effective Oct. 1, 1942, of the revenue bill of 1942 (H. R. 7378) as passed by House of Representatives July 20, 1942*—Continued

[In millions of dollars]

General and special accounts	Estimated receipts, present law (April 1942 revision)	Increase or decrease (−) due to revenue bill of 1942	Estimated receipts, present law plus revenue bill of 1942
1. Internal revenue—Continued.			
(2) Miscellaneous internal revenue—Continued.			
Retailers' excise taxes:			
Jewelry, etc.	54.0	.....	54.0
Furs	46.3	.....	46.3
Toilet preparations	28.0	.....	28.0
Total retailers' excise taxes	128.3	.....	128.3
Miscellaneous taxes:			
Telephone, telegraph, radio and cable facilities, leased wires, etc.	52.8	10.1	62.9
Telephone bill	55.2	15.1	70.3
Transportation of oil by pipe line	14.8	.....	14.8
Transportation of persons	34.0	11.9	45.9
Admissions	143.6	.....	143.6
Club dues and initiation fees	7.2	.....	7.2
Leases of safe deposit boxes	4.2	.....	4.2
Use of motor vehicles and boats	149.2	.....	149.2
Coconut and other vegetable oils processed [1]	2.4	.....	2.4
Oleomargarine, etc., including special taxes and adulterated butter	2.5	.....	2.5
Bituminous coal tax	5.5	.....	5.5
Sugar tax	49.9	.....	49.9
Coin-operated amusement and gaming devices	6.2	4.4	10.6
Bowling alleys and billiard and pool tables	2.0	.....	2.0
Transportation of property	.....	84.3	84.3
Pari-mutuel wagering	.....	5.9	5.9
All other, including repealed taxes [4]	.8	.....	.8
Total miscellaneous taxes	530.3	131.7	662.0
Total miscellaneous internal revenue (collection basis)	3,937.3	499.1	4,436.4
Adjustment to daily Treasury statement basis	.....	.....	.....
Total miscellaneous internal revenue (daily Treasury statement basis)	3,937.3	499.1	4,436.4
(3) Employment taxes:			
Taxes on employment by other than carriers:			
Federal Insurance Contributions Act	1,470.5	.....	1,470.5
Federal Unemployment Tax Act	159.6	.....	159.6
Total	1,630.1	.....	1,630.1
Taxes on carriers and their employees (ch. 9, subchap. B of the Internal Revenue Code)	199.9	.....	199.9
Total employment taxes	1,830.0	.....	1,830.0
Total internal revenue	17,798.3	4,085.1	21,883.4
2. Railroad Unemployment Insurance Act	9.8	.....	9.8
3. Customs	245.0	.....	245.0
4. Miscellaneous revenues and receipts	284.2	.....	284.2
Total receipts, general and special accounts	18,337.3	4,085.1	22,422.4
Deduct: Net appropriation for Federal old-age and survivors insurance trust fund representing an amount equal to taxes collected and deposited under the Federal Insurance Contributions Act, less reimbursement to general fund for administrative expenses	1,441.3	.....	1,441.3
Net receipts, general and special accounts	16,896.0	4,085.1	20,981.1

[1] Collections for credit to trust funds are not included.
[3] Includes $319,800,000 to be collected at source and credited against taxes collected in 1944 on 1943 incomes.
[3] Revised subsequent to the April Budget revision.
[4] All other, including repealed taxes. Includes brandy used for fortifying sweet wines; tobacco floor-stocks taxes; toilet preparations 5 percent and 11 percent; narcotics, including marihuana and special taxes; National Firearms Act; hydraulic mining tax; and all other repealed taxes not reinstated by the Revenue Act of 1941.

Source: Treasury Department, Division of Research and Statistics, July 21, 1942.

Mr. O'DONNELL. In analyzing the figures presented in exhibit G, it is necessary to realize that some of the provisions in the bill will not be reflected in any way in the fiscal year 1943 receipts. For instance, gift tax provisions apply only to gifts made after January 1, 1943, and the gift tax due with respect to gifts so made would not be due until March 1944, which falls in fiscal year 1944. Although the provisions of the estate tax take effect upon the effective date of the new legislation with respect to the estates of persons dying after that time, estate tax returns need not be filed for 15 months following such date.

Certain of the excise provisions, such as those applying to taxes which are collected through the sales of stamps, will be reflected in larger current collections almost immediately after the provisions become effective. From other excise taxes, such as the manufacturers' excise taxes, collections are not received by the Federal Government until the end of the month following the month in which the new provisions first become effective. In the case of certain other taxes, such as the tax on transportation of property, the bill provides for an extension of time at the discretion of the Commissioner of Internal Revenue in the payment of the tax. Under the Internal Revenue Code extensions of time are allowed in the payment of the various taxes, such as telephone and telegraph taxes. The effect of the bill on these telephone taxes will be delayed in fiscal year 1943 to the extent that such extensions exist.

In interpreting the income tax estimates of receipts in fiscal year 1943, it is important to remember that under present law, receipts which are expected in the fiscal year 1943 include the collections of the two final installments in respect of calendar year 1941 income-tax liabilities.

With respect to the collection of the calendar year 1942 individual income-tax liabilities, whether under present law or under the proposed bill, some payments are made in full but with respect to the bulk of the amount due only two of the four installment payments are received during the fiscal year 1943. The fiscal year 1943 figure for the individual income tax is further complicated by the inclusion of $319,800,000 to be collected at the source and credited against income taxes to be collected in calendar year 1944 on calendar year 1943 incomes. Furthermore, certain provisions of the bill have a different effect in the actual calendar year 1942 than they have in a full year at 1942 levels of income in which all provisions of the bill would be fully reflected in revenues. This is particularly true of the proposal to tax 1942 net income of corporations with fiscal years which end in 1942 other than December 31, and of the capital gains and loss provisions which are not fully reflected in actual calendar year 1942 because of the nonoperation to the full extent of the 5-year capital loss carry-over.

The CHAIRMAN. Mr. O'Donnell, I would like to ask in this connection—I don't know whether you can give it now, but will you furnish it for the committee and put it in the record—the amount of the base on which the several taxes in here, as calculated, are applied in making up the estimates on the House bill?

Mr. O'DONNELL. Yes, sir. I think I have in mind the type of information you want.

The CHAIRMAN. That is excess-profits tax, the normal and surtax, individual, and so forth.

Mr. O'DONNELL. Yes, sir; I will be very glad to do that. I have the information with me, but I do not have it in the tabular form that I think would be most useful to the committee.

The CHAIRMAN. Will you give us that?

Mr. O'DONNELL. I will be very glad to. I will put that in the record so that it can be printed up tomorrow.

The CHAIRMAN. Yes.

(The table referred to is as follows:)

EXHIBIT H.—*Income and excess-profits taxes—Estimated individual income and corporation income and excess-profits tax bases for taxable individuals and corporations only, at levels of income estimated for calendar year 1942, under the revenue bill of 1942 (H. R. 7378)* [1] *and under the present law*

[In millions of dollars]

	Revenue bill of 1942	Present law
Individual:		
Normal tax net income	20,220	22,480
Surtax net income	31,530	26,300
Corporation:		
Normal tax net income	10,010	13,120
Surtax net income	10,330	13,430
Excess-profits tax:		
Excess profits net income	13,210	12,540
Excess-profits credit	6,310	5,640
Specific credit	360	220
Adjusted excess profits net income	6,570	6,680

[1] As passed by the House of Representatives, July 20, 1942.

Source: Treasury Department, Division of Research and Statistics, July 23, 1942.

The CHAIRMAN. Now, all right, Senator Brown.

Senator BROWN. That was the question I wanted to ask, the question you just covered.

Mr. O'BRIEN. Page 51, line 16, relates to the computation of net operating loss credit and dividends paid credit in the case of companies subject to the tax under section 102. That is, companies improperly accumulating surplus and personal holding companies.

The amendments are purely technical, to straighten out a kink in the present law in which the limitations are geared to the adjusted net income instead of to the base upon which the tax is founded, to wit, section 102 net income or a personal holding company net income, as the case might be.

The present law, as I say, is out of whack on that point. In some cases it gives the corporation too much and in some cases too little. It is a purely technical amendment to straighten that out.

Senator CONNALLY. That is our friend, about personal holding companies; isn't it?

Mr. O'BRIEN. It has to do with personal holding companies, Senator, but it is just a mistake in the present law, in determining how much net operating loss they carry from the previous year to this year and where their dividends paid credit is carried over.

Page 54, line 17, begins a series of provisions which relate to the income which, under the present law, is includible in the income of a decedent in the year in which he dies. Since 1934 the law has read that in the case of a decedent there should be included in his gross income for the year of his death all amounts accrued up to the date of his death. The Supreme Court in the *Phaff* and *Enright cases*

has given a very broad construction to that language, so that in the case of an insurance agent's renewal commissions, they have held that all such renewal commissions are includible in his income for the year in which he dies.

This proposes to go back to a rule which might have been the rule enacted in 1934, that as to those matters you accrue only what would have accrued under an accrual system of accounting. You exclude from the rest of his income in the year in which he dies such amounts and include that amount in the income of the person who actually does get the income. In the ordinary case, that would be his estate, or if it descends directly to his heir it will be taxable to his heir.

Senator CONNALLY. Under the present law, suppose a man leaves an estate, and suppose that estate is not wound up for years, can that estate return the income as an estate matter and not be taxable to the recipients?

Mr. O'BRIEN. Yes.

Senator CONNALLY. That is the law now.

Mr. O'BRIEN. Yes; sure.

Senator CONNALLY. Does this change that?

Mr. O'BRIEN. No; this does not change it at all. Well, let me put it this way: Under the present law, let's take an insurance agent's renewal commission, which he has not yet received. The Supreme Court says, under the statute as it stands, that $100, let us say, goes into the income of the decedent for the year in which he dies. The estate, of course, will pay his income tax on that. Under the present law, when that $100 comes to the estate, as the law now reads, that is not income to the estate. So they pay no tax on it. However, the amount or the value of that right to receive income is includible in the decedent's gross estate, and hence taxable under the estate tax. This proposes to say that that $100 is not income to the decedent, so the decedent and the estate pay no tax on account of his income. The amount, however, is included in the gross estate of the decedent; hence the estate tax is paid on it.

This says if the executor gets that $100 it is income to the executor, but this also provides that with respect to that $100 there shall be allowed as a deduction an amount equal to the pro rata share of the estate tax which that $100 represented in the gross estate of the decedent.

Senator CONNALLY. What I had in mind was this: Suppose the estate dragged along for 2 or 3 years.

Mr. O'BRIEN. Right.

Senator CONNALLY. The estate may return that income as the estate of the decedent.

Mr. O'BRIEN. Yes.

Senator CONNALLY. And they pay on it as such.

Mr. O'BRIEN. That is right.

Senator CONNALLY. And the ultimate recipients would not have any obligation at all until they received their share from the estate.

Mr. O'BRIEN. That is right.

Senator CONNALLY. And it would then be taxable as an inheritance.

Mr. O'BRIEN. Well, it might be subject to inheritance tax in the hands of the beneficiary, but not subject to an income tax.

Senator TAFT. I understand that would apply in the case of a lawyer——

Mr. O'BRIEN. A contingent fee is a good example.

Senator TAFT. Suppose a lawyer dies and he is owed a fee of $5,000 when he dies. Do I understand that his estate has to pay an income tax on that $5,000? First, the $5,000 is included in his estate, because it is a fee due to him.

Mr. O'BRIEN. Yes.

Senator TAFT. But he is on a paid basis.

Mr. O'BRIEN. Yes. That is under cash receipts and disbursements.

Senator TAFT. That is a receipt basis.

Mr. O'BRIEN. Yes.

Senator TAFT. So he doesn't return it as income in his individual return.

Mr. O'BRIEN. Are you talking about the present law or the new?

Senator TAFT. The new proposal.

Mr. O'BRIEN. Under the new proposal it is not included in the decedent's gross income for the year of his death, but is includible in the income of the estate.

Senator TAFT. It is included in his estate.

Mr. O'BRIEN. Yes.

Senator TAFT. And he pays an estate tax on it.

Mr. O'BRIEN. Yes.

Senator TAFT. Then, the executor has to pay a proportional amount out of the $5,000 due him, and, say, $2,000 of it represents the estate tax and the other $3,000 is then income to the estate. Is that the effect of this law?

Mr. O'BRIEN. Yes. $3,000 is income to the estate, but the estate gets a deduction for the pro rata part of the estate tax paid on account of that.

Senator TAFT. Yes. Deducting the paid 40-percent estate tax, that would be $2,000 to come off of the $5,000, and $3,000 would be income to the estate.

Mr. O'BRIEN. That is right. Actually, the $5,000 is income to the estate, but it gets a deduction on account of its pro rata part of the estate tax paid. I did not follow your mathematics but assume your arithmetic was correct; that is the principle.

Senator DANAHER. How do you compute the present value as of the date of the death of the decedent?

Mr. O'BRIEN. I don't know. I suppose it is a question of valuation.

Senator DANAHER. You have an actual appraisal of the property?

Mr. O'BRIEN. Yes; you must have an appraisal, but as to the method of appraising, I am not familiar with that. I assume that has a value, just as any other claim which the decedent has.

Senator DANAHER. The renewal is 5 years hence and may never be paid. Actually, the policy may lapse. I wonder how you would appraise it.

Mr. O'BRIEN. I don't know.

Senator DANAHER. Do you know, Mr. Paul?

Mr. PAUL. You would discount that for the time factor and then again you would have to take into consideration the hazard, by which I mean that the insured might not pay the premium, and when you got through you would reduce the total amount payable 5 years hence in accordance with some appraisal.

Senator DANAHER. And leave it as a question of fact in any given case?

Mr. PAUL. That is right.

Mr. O'BRIEN. Further, to carry out the analogy of the estate, or the heir which gets this income, as being in the shoes of the decedent, the character of the income, if it had been received by the decedent, determines the character of the income in the hands of the recipient. That is, if it would be earned income of the decedent if he had gotten it, it is treated as earned income on the part of the heir. If it is capital gain to the decedent, it is capital gain to the heir.

Senator TAFT. But you still have to separate income tax. You don't regard the individual as a continuing entity until the end of the fiscal year.

Mr. O'BRIEN. No, no; you don't do that. He chops off at death.

This provision is made retroactive to the taxable year beginning after December 31, 1933, but only if the estate and the people acquiring the property from the estate say that it shall be. It is designed to be a relief provision, relieving the decedent as to his last year of life from the tax, but it relieves him retroactively only if the people who get the income agree to take it up. They would be obligated to take it up if this law had been in effect with respect to them. Again, as to the closed years, the provision is not applicable, but I understand most of these cases are open.

Page 64, line 12, relates to placing the income of a corporation on an annual basis.

Senator DANAHER. Mr. Chairman, before you open on that page 64, suppose that a husband dies and all his estate goes to his wife; suppose she claims a deduction for some item which is disallowed on the ground that it would have been allowable only to the husband, but suppose the years in which he could have taken an allowance had passed, is there any way in the world in which that situation is met in this bill?

The reason I ask that is that in behalf of a constituent I sent a case, specifically on those facts, down to the Treasury recently, and I was told by way of reply that there had been no adjudication on such a question. I wonder if you know of any language meeting such situation in this bill.

Mr. O'BRIEN. No, I do not; at least, it has not been a problem that has come up in this bill.

Senator DANAHER. Don't let's spend any time on it now. We can take it up later.

Mr. O'BRIEN. Page 64, line 12, relates to placing returns of a corporation on an annual basis. Under the present law, in the case of the corporation having a taxable year of less than 12 months, the income is not put on an annual basis for the purpose of the corporation's normal tax and surtax. It is for the purpose of excess-profits tax.

Of course, when you have a flat rate of tax, it does not make any difference whether the income is put on an annual basis or not. This proposal is that in a case of a taxable year which is less than 12 months, then you ascertain what would be its annual income for the purpose of applying graduated rates by multiplying the amount of the income by 12 and dividing by the number of months in the short period. You see, you have the same problem in connection with the graduated corporation normal and surtax as you have in the case of

an individual. An individual, for instance, having a short taxable year of say 6 months and earning $5,000, though actually he is earning $5,000 in 6 months, which would be at the rate of $10,000 a year, in order to put him in the proper bracket, you put the income in on an annual basis. This proposes to do the same thing in the case of a corporation, with two exceptions. It is conceivable that by reason of that rule there might be some hardship to a corporation whose income happened to fall in the short period and they would not normally earn at the same rate during the succeeding part of the year. It is proposed in such cases to provide that they can take the 12 months beginning with the beginning of the short period and use that as the measure of the tax for the short period, or in cases in which the corporation was not in existence for 12 months at least, after the end of the short period, they can take the back period beginning with the end of the short period. In other words, the corporation has got an opportunity to show, in case it continues in existence, what would be its income for the full 12 months, and not have this formula for the ascertainment of the amount of what the income would be if it was put on an anual basis.

Senator VANDENBERG. Has this got anything to do with the question which I asked when we started out?

Mr. O'BRIEN. No, Senator.

Senator VANDENBERG. All right, when we get to it.

Mr. O'BRIEN. Section 129 of this bill, 108 of the Internal Revenue Code.

Page 68, line 10, is a purely technical amendment to the taxation of section 102 companies; that is, companies which improperly accumulate surplus. Under the present law a section 102 company is allowed a carry-over of a capital loss. That, itself, constitutes a loophole because section 102 companies are allowed their capital losses. The effect of giving them capital losses in the year in which they sustained them and a carry-over of a capital loss to a future year is to give them the capital loss twice. This proposes to give them the capital loss but once and that for the year in which it is sustained, with no carry-over to a subsequent year.

Page 69, line 1, begins a revision of the provisions under which certain classes of taxpayers are allowed, in effect, to spread certain kinds of income over a longer period, over the period roughly in which it was earned. Under the present law in the case of an individual who renders personal service extending over a period of more than 5 years, if he receives 95 percent or more of that income in the sixth year, let's say, he is permitted to pay a tax on the 95 percent equal to the amount which he would have paid had the amount that he got this year been spread over the years in which he did the work in equal installments.

First, it proposes to make a reduction in the 5-year period under the present law to 36 months. That is, the work done and the compensation for personal services must be over a period of 36 months or more. The second change proposes to reduce the 95-percent test amount to 80 percent. For taxable years beginning after December 1940, and not after December 31, 1941—that is, the taxable period in 1941—it is made retroactive, but the period is made 60 calendar months and the

percentage is 75 percent instead of 80 percent. So you have three rules: Back years, 5 years and 95 percent; 1941, 60 months and 75 percent; for this year and future years, 36 months and 80 percent.

Senator CONNALLY. What effect, if any, would that have on an individual this year, for instance, after war was declared, who would make a big profit? Could he spread it over 5 years or 36 months?

Mr. O'BRIEN. If he had been working on it that long. This contemplates a continuous service over that period and at least 80 percent of the income falling within a year.

Senator CONNALLY. I say, he made the bulk of his money this year, and this would permit him to spread his profits out over 36 months if he continued to work on the job?

Mr. O'BRIEN. That is right, if he continued to work all that time and had not gotten paid for it. This provision is further expanded to include the case of a person who composes a literary, musical, or artistic composition, or has a patent or copyright covering an invention or composition of his. If the work on it covered a period of 36 calendar months from the beginning to the completion of the composition or invention, and then if in the taxable year the amount which he received, together with the amount which he received in the next succeeding taxable year is not less than 80 percent of the income, not less than 80 percent of the entire amount he got during those years, then he equally can spread that amount over 36 calendar months ending with the close of the taxable year in which he received the sum. This extends slightly different but substantially the same relief to authors, inventors, and musicians.

The CHAIRMAN. He can spread it over the actual time required to do the work if he had a minimum of 36 months?

Mr. O'BRIEN. No; this does not spread it over the actual time; it spreads it over 36 months even if he worked on it 10 years.

The CHAIRMAN. He just gets the three installments.

Mr. O'BRIEN. That is right.

The CHAIRMAN. And if he is writing a book for 5 years, then he could not get that in 5 years?

Mr. O'BRIEN. No; he could not spread it more than 36 months.

The CHAIRMAN. So the author had better complete his work in less than 5 years.

Senator BARKLEY. If the man cannot tell all he knows in 3 years he had better quit now.

Mr. O'BRIEN. Then, the next is page 70, line 24, which deals with fiscal year taxpayers, of which Senator Vandenberg spoke.

Senator VANDENBERG. Where?

Mr. O'BRIEN. Page 70, line 24.

Senator VANDENBERG. Tell me about that.

Mr. O'BRIEN. Ever since 1934, the income-tax acts have provided that the changes made in them shall be only applicable to taxable years beginning after a particular time, and in every case it has been the end of the year. This provision constitutes an exception from that rule, and says, in the case of the taxpayer who has a taxable year ending in 1942 and beginning in 1941, that he shall compute his tax, making his computation first for the period beginning 1941 and ending in 1942, computing his tax under the old law, and take a proportion of that tax which the number of months falling in 1941 bears to the entire number of months. He then computes the tax for the entire

period beginning in 1941 and ending in 1942, under the 1942 law, and takes the same proportion, takes the proportion of that tax which the number of months falling in 1942 bears to the entire number of months in his entire taxable year. He then adds those two proportional amounts together and that is the tax for the taxable year ending in 1942. So that if you had a case in which a man, let us say, had a net income of $1,200, and part of that was earned in 1941 and part in 1942, suppose he had 8 months in 1941 and 4 months in 1942. He computes his tax on $1,200 at the old rate, and takes eight-twelfths of that amount; he computes his tax on $1,200 at the new rate and takes four-twelfths of that amount. Adding those two together gives his tax for the taxable year 1942.

Senator VANDENBERG. That applies for corporations as well?

Mr. O'BRIEN. It applies to corporations, individuals, everybody except specified corporations which are exempt from it: First, insurance companies; second, foreign personal-holding companies; third, regulated investment companies; fourth, section 102 companies—that is, companies improperly accumulating surplus—and, fifth, personal-holding companies.

Senator VANDENBERG. Does that result in putting a corporation which had a fixed fiscal year and considered that it had its tax liability closed and financed itself accordingly under a retroactive disadvantage which might be totally fatal?

Mr. O'BRIEN. I cannot answer on that. The thing is retroactive. Whether the effects are bad or not is a matter of policy.

Senator TAFT. This used to be the rule, as I remember, in the old days, and it was changed.

Mr. O'BRIEN. Yes.

Senator TAFT. What is the reason for changing it back again?

Mr. O'BRIEN. That is not my problem, sir.

Mr. PAUL. As to the theory of this thing, I think perhaps that Mr. Stam ought to answer the question.

Senator VANDENBERG. Don't tell me Mr. Stam is responsible for this.

Mr. PAUL. It is not a Treasury subsection, but the theory is that a corporation with a fiscal year ending November 30, that corporation is escaping, for 11 months of the calendar year 1942, the impact of the new very decidedly higher applicable calendar-year rate.

Senator TAFT. Why was it changed before?

Mr. O'BRIEN. I think, perhaps, Mr. Stam, I can answer that.

Mr. STAM (Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation). I think I can tell you the story, if you want me to.

You see, naturally, it is very simple when changing a revenue law to have it apply to taxable years beginning after the beginning of the effective date of the act. For example, if we were passing a tax law for the year 1941, we would apply it to taxable years ending after December 31, 1939. It simplifies the law and does not make much difference as long as rates are not as substantially increased, but when you come to a period when the rate is increased very rapidly, it gives a great advantage to the corporation on the fiscal-year basis. For example, a corporation that had a fiscal year ending November 30, 1940, would have 11 months of 1940 income, on which it paid no excess-profits tax at all on that 1940 income.

Now, the same corporation with a fiscal year ending November 30, 1941, instead of paying the increased 1941 rates on that 1941 income, only paid at the 1940 rate.

Now, we have increased the excess-profits tax rate tremendously in this bill. We have gone up as high as 90 percent, and the old rate, the top rate, was 60 percent. We have increased the normal and surtax rate from 31 percent, under the old bill, to 45 percent.

If a corporation has a fiscal year ending, say, November 30, 1942, it will escape these high rates on 11 months of its 1942 income, and we didn't feel that that was an equitable proposition as compared with the calendar-year corporation. The calendar-year corporation may be getting profits from Government contracts, and the fiscal-year corporation may be getting like profits from Government contracts, both in 1942, and it did not seem to us altogether fair to apply the lower rates to the fiscal-year corporation merely because of its method of accounting, when all of that income was earned in 1942, and there is a very great discrimination between the calendar-year corporations and the fiscal-year corporations if you are not going to apply the increased rates to the fiscal-year corporation.

The Canadians apply a rule something like we have in this bill to tax the income that is earned after the effective date of the act at the same rate. So do the British companies, and that is the reason for this change.

Senator TAFT. Has there been any indication or tendency to take advantage of this by moving the fiscal year toward the end of the calendar?

Mr. STAM. There has been, as the result of the increased rates last year. Particularly some of the aviation companies and others having war contracts have changed their taxable years over to a fiscal-year basis in order to take advantage of these lower rates.

Senator TAFT. But the Commissioner could have prevented that by refusing to permit them to make that change.

Mr. STAM. He could have, and I understand he has in some cases.

Senator TAFT. Yes.

Mr. STAM. But the inequity is still there with respect to the corporations that have been on this fiscal-year basis for a long period of time.

Senator VANDENBERG. I think that is a very persuasive statement from the standpoint of relative equity, but it seems to me you have still left the corporation, perhaps, at a fatal disadvantage, whom you allowed to makes its budget on a given tax basis, and now you come along and destroy it, isn't that true?

Mr. STAM. Well, it seems to me, in answer to that question, that the corporation probably should have anticipated that something like this was going to happen. There was a lot of agitation about this situation in 1940. I remember a Member of Congress was very much agitated about it and wanted to rush through a joint resolution at that time; and we have talked about this thing considerably in the last 2 or 3 years. It seems to me that a corporation that went ahead blindly and did not take into account that there might be some change along this line——

Senator VANDENBERG. He went ahead blindly and depended on the Government's word.

Mr. STAM. I do not think that is altogether true for the reason that when the change was made in 1934 it was made with the under-

standing that there was no increase in rates at that time. It was solely on this basis that Senator Couzens withdrew his objections to this change of policy.

Senator TAFT. What about the situation of a corporation that had to pay out its money, came to the end of the year, say, or the 1st of July, and under section 102 had to pay out all its profits in dividends for fear of being penalized, and now you come along and by a retroactive tax which takes away not only what they had left but probably a large part of the money they had paid on dividends. Does it apply to that kind of a corporation?

Mr. STAM. No; we are not applying a retroactive tax. This provision applies only to that part of the income received after January 1, 1942.

Senator TAFT. Take a corporation whose fiscal year ended the 1st of July, when they got to the end of that year they figured their taxes on the old rate, then they are required by section 102 to pay that all out in dividends, or most of it out in dividends, for fear of becoming subject to section 102, the penalty if you don't pay out dividends. And now you come along and make them recalculate their tax for those 6 months of 1942, and you have got them in a box.

Senator VANDENBERG. A pine box.

Senator TAFT. They may have even violated the law which prohibits the payment of dividends from surplus, because what they paid out is no longer profits.

Mr. STAM. But that corporation, of course, would not file its tax return until October because that return wouldn't be due until then. We have had no situations of that sort. Moreover, it should be remembered that a liability which did not exist at the close of the taxable year will not reduce the earnings and profits of a corporation for that year, so far as dividends actually received by the shareholders are concerned. Such a situation arises daily in the case of additional assessments of income taxes made after the close of the year.

Senator TAFT. But it could be.

Mr. STAM. Yes. I do recall this, under the 1918 tax, which was passed February 24, 1919, and was retroactive to January 1, 1918, that some corporations actually went out of existence before the act was passed, and those corporations were required, that is, the trustees or representatives of those corporations were required, to file a supplemental return covering the income for the period in 1918 in which they were in existence, although they had actually dissolved before the act was passed, because we were levying a tax on 1918 income. A number of those cases arose, I know, under the 1917 and 1918 acts.

I don't think there was any great criticism of that situation because there we were trying to collect an excess-profits tax on 1918 income. Here we are trying to collect at these high rates which are applicable to 1942 on 1942 income, and I don't believe that any corporation can say that they were very much surprised by this provision. If they were, it seems to me they were very foolishly surprised, because we have talked about it informally for several years.

Senator TAFT. I am not thinking of surprise, I am saying that the corporation in the case I cited was compelled by the existing law to pay out as dividends money that you now say they should pay in taxes. That is the thing that worried me somewhat.

Mr. STAM. I don't believe any corporation at the present time that is engaged in any sort of activity, particularly war activity, would be compelled to pay out dividends, because I think most of them could find some need for retaining their earnings in the business.

Senator VANDENBERG. Well, what happens to that company? Here is a company, this is a realistic case—here is a war contractor who at the urgent insistence of the Government commits its entire prospective net revenue for its fiscal year to new machinery for the purpose of responding to the war effort. Now, how are they going to pay for it when you come along and say that they had no right to depend on this Government tax program and that two-thirds of the investment they have made in inventory has got to be duplicated in taxes?

Mr. STAM. What can the calendar-year corporation do in that case? It has to pay its tax on its 1942 income.

Senator VANDENBERG. But it knows in advance precisely what to figure on.

Mr. STAM. Well, this other corporation, of course, has been able to accumulate a considerable reserve at the expense of the calendar-year corporation by virtue of the fact that it was not subject to any excess-profits tax in 1940 and was subject to a very low excess-profits tax rates in 1941. In other words, that corporation has gotten quite a bonus in the past, it seems to me.

Senator DANAHER. Mr. Chairman——

The CHAIRMAN. Senator Danaher.

Senator DANAHER. May I read a few words right there on that point from a telegram at hand?

The CHAIRMAN. Yes, sir.

Senator DANAHER (reading):

> Many companies, such as ours, have undertaken large contracts for war products which have required unusual bank borrowings and substantial investments in plant, which although justified today by contemplated operation, result, after taxes based upon the 1941 act, would be unwarranted by the net operating result after taxes under the proposed new act. The necessity for high tax rates is recognized but it is also important to preserve the financial position of important manufacturers of war products who are on a fiscal-year basis. Our fiscal year started December 1, 1941, and our plans for additional manufacturing facilities and financing for this fiscal year were adopted originally upon the 12 months of operation under the 1941 act instead of only 1 month under such act and 11 months under the proposed 1942 act.

Does that raise a typical case such as the Senator from Michigan spoke of?

Senator VANDENBERG. Precisely.

Mr. STAM. That corporation has 11 months of 1942 operation and the calendar-year corporation has 12 months. Now, the calendar-year corporation would be subject to a rate of 90 percent, and if we leave the old rule in, that corporation would only be subject to a rate of maybe 60 percent on its 1942 operations.

Senator TAFT. Would it be feasible to take it as of the day the House passed the tax bill instead of the first of January, dividing it on that basis, so far as this year is concerned only?

Mr. STAM. Of course, my point was that this is the year in which we have made a drastic increase in the rates. We are up to 90 percent now, and, of course, we have increased our surtax considerably. So that if this change isn't made this year, in 1942, I don't believe it will be much use in making it next year, because I don't believe we can go very much further.

Senator TAFT. I was suggesting that you go back to the day that the House passed the tax bill rather than the first of July, if possible.

Mr. STAM. Well, of course, there you discriminate somewhat against those corporations. It wouldn't do Senator Vandenberg's case any good, or the other cases any good, when the fiscal year closed before the adoption of the House bill. It seems to me it would be better to apply those provisions to all fiscal-year corporations than to distinguish between those whose fiscal years happened to end merely after the passage of the House bill. We have provided in this amendment that those corporations that are required to pay any additional tax due to the 1942 rates can file a supplemental return on March 15 of next year and pay that tax. In other words, they won't have to file the return before that time.

Senator TAFT. If you don't give them back the money they may not have any more to pay it with.

Mr. O'BRIEN. There is no such thing in the bill on that point.

Mr. STAM. We talked about it.

Mr. O'BRIEN. Something needs to be done about it. I want to say that the bill does not provide for any such thing.

The CHAIRMAN. It was left out, you mean, or was just not included?

Mr. O'BRIEN. Was not included because we did not have time to work it out.

Senator VANDENBERG. Do I understand you to say the Treasury didn't recommend this, or didn't you think of it, or something?

Mr. PAUL. I may say the Treasury was cognizant of the problem but did not make any recommendations on this point. The study of the point went on through the hearings. The suggestion was made late in the executive session of the Ways and Means Committee. While I would support the change on balance, I think that there are problems to be worked out, and that the problem that Senator Danaher cited is a typical problem which must, frankly, be faced. I do not know how it can be solved. Senator Taft's hypothetical case is not entirely a hypothetical case; it may be a real case, and I am frankly troubled by it, but my present impression is that on balance the inequity or disparity between the situation of calendar-year corporations and fiscal-year corporations, especially fiscal-year corporations with fiscal years ending late in the calendar year 1942, is a serious one that ought to have some treatment, if it is not too much of a hardship.

Senator BYRD. How much revenue does it bring in?

Mr. PAUL. $148,000,000. There is another angle to the problem, and that is what will happen if ever the rates go down at some point in the future. If the rates stayed the same we would make up this loss of revenue then, but that is so problematical that I don't think we can figure very much on it.

Senator TAFT. I hoped you would give us some hope.

Senator VANDENBERG. I am hopeful because he says that he is troubled by it.

Senator CONNALLY. Is there any sound reason why they should not be all on the same basis? Why should one corporation have a fiscal year on the 1st of July and another one on another date, for taxation? Why shouldn't they all be on the same basis?

Mr. PAUL. There are several reasons, Senator Connally. The seasonal business of certain corporations makes the fiscal year more adaptable.

Senator CONNALLY. It may be for their convenience, but from the Government's standpoint it should be from January 1 to January 1. All this talk about the promise of the Government—anyone who has got enough sense to be in a corporation knows that the Government can change the tax laws whenever they get good and ready.

Mr. PAUL. That is right, and I think there is much in what Mr. Stam says about people, particularly since December, being required to a certain extent to be aware of these possibilities in the corporate picture. I think they all ought to be on the same basis, just as I think all estates ought to be on the same basis. I don't think there ought to be community estates, but the fact remains that there are.

Senator CONNALLY. If the Senator has got as much influence at home as he has got here, why doesn't he fix his State?

We run our own affairs and he runs his.

Senator JOHNSON. What do you think of the proposition of Senator Taft, Mr. Paul, of not going back of July 1?

Mr. PAUL. I agree with Mr. Stam, as I understood him on that. It seems to me that we ought to do it or not to do it completely or it wouldn't be worth all the trouble.

Senator JOHNSON. For 1 year.

Mr. PAUL. There is a tremendous amount of trouble about this provision. We have to adjust the difficulties mentioned on page 92 of the House committee report, and some of them haven't been worked out yet, and if we broke in the middle of the year, I don't think it would be worth the whole trouble. We ought to go the whole hog or not do it at all.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. I want to call your attention to an important typographical error on page 73, line 3. That 139 should be 142.

The CHAIRMAN. Where is that?

Mr. O'BRIEN. Page 73, line 3.

Senator DAVIS. 70 what?

Mr. O'BRIEN. Page 73, line 3.

Senator CONNALLY. 139?

Mr O'BRIEN. 139 should be 142. It is an erroneous cross reference.

Senator CONNALLY. All right.

Mr. O'BRIEN. I guess you got the general principle of that. I can go into detail for you on it if you want me to.

The next change is on page 74, line 17, which is purely a technical clarifying amendment to the present law.

Senator TAFT. We are now on something else. Is it on gift taxes?

Mr. O'BRIEN. No; still income taxes.

Under the present law, in section 113, which relates to the basis for determining gain or loss and the basis for depreciation, there is some doubt as to whether a gift in trust falls under paragraph (2) of section 113 (a), or paragraph (3) of section 113 (a) which provides a different basis. The most important difference being that in the case of a gift the basis for determining loss is the fair market value, if the basis in the hands of the donor is greater than the fair market value. This proposes to clarify the statute by providing that in the case of gifts in trust they shall be subject to the gift rule rather than the transfer in trust rule.

Senator TAFT. Is that retroactive?

Mr. O'BRIEN. No; it is not retroactive—well, it is retroactive in this sense—I mean it does not relate merely to gifts made hereafter. It relates to the basis of gifts no matter when made for the purpose of a future determination with respect to the basis of the gift. That is, if you make a gift after 1920, after December 31, 1920, made a gift in 1935 and the donee sells in 1943, this rule applies. And the rule, of course, naturally applies to all gifts in trust in taxable years beginning after December 31, 1941. To that limited extent it is retroactive.

Page 75, line 14, relates to percentage depletion in the case of fluorspar mines. The allowance for depletion shall be 15 percent, the same rate as applies to metal mines.

Senator GUFFEY. That is the only change in that provision?

Mr. O'BRIEN. Yes. It does not affect oil, or otherwise, it merely lets in the fluorspar mines at the same rate as other mines.

My attention has been called to the fact that there has been eliminated from this section the requirement first placed in the statute in 1934, that the taxpayer, to get percentage depletion, had to elect percentage depletion and stick by it.

Senator TAFT. Is this the section the Secretary doesn't like, the provision he did not want put in?

Mr. O'BRIEN. No; it is in the same section but the other provision relates to oil and gas and this is merely coal mines, fluorspar mines, and sulfur mines.

Senator TAFT. The other applies solely to oil.

Mr. PAUL. Oil and gas.

Senator TAFT. Oil and gas.

Mr. PAUL. Oil and gas and mines, too; but this particular amendment, as long as percentage depletion was allowed, we thought should be allowed. In other words, we were against percentage depletion, but if percentage depletion is in the statute it ought to apply to fluorspar as well as the others.

The CHAIRMAN. At one stage in the House bill was fluorspar eliminated?

Mr. PAUL. No; fluorspar was given discovery depletion under the existing act and the change made was to grant them percentage in lieu of discovery depletion.

Senator TAFT. I was a little surprised because the Secretary's statement this morning said "another highly privileged group having large amounts of income exempt from income tax are the owners of oil wells and mines."

Mr. PAUL. Doesn't it say "and mines"?

Senator TAFT. Yes; it does; "and mines."

Mr. PAUL. I thought so.

Mr. O'BRIEN. Senator George, at one stage of the House bill the fluorspar rate was 5 percent and later was made 15 percent. I think that is what you were thinking of.

The CHAIRMAN. It was given a different treatment in another stage.

Mr. O'BRIEN. Five percent, and then raised to 15; yes.

Senator JOHNSON. What is the present law?

Mr. O'BRIEN. Given discovery depletion. It is not given percentage depletion at all.

Page 76, line 12, is another purely technical amendment of the revenue act. The Second Revenue Act of 1940 wrote in provisions for the determination of earnings and profits which were necessary to establish the taxability of dividends and for the purposes of excess-profits tax. Under that provision earnings and profits were not increased by a so-called unrecognized gain. This proposes an almost clerical amendment to accomplish the same result in cases in which there are wash sales, that is, you trade one share of stock for, and later get, another. I think if we had thought of it in writing the 1940 bill it would be in the 1940 bill. It is purely technical.

Page 77, line 1, amends section 115, which relates to corporate distributions. Under the present law a distribution in partial liquidation of a corporation is treated as a capital gain, if there is a gain, and 100 percent is taken into account. That is, for that purpose the gain on the stock is considered just as if it were a short-term gain, regardless of the period for which it was held. This provision proposes to abrogate that rule so that in cases in which there is a partial liquidation of a corporation, when the stock is redeemed it is—the gain thereon is taxable as a capital gain, but the holding period of the stock is whatever the period for which the stockholder held it and it is not considered to be a short-term gain. The effect of that, of course, being to reduce the amount of gain which is recognized on the transaction if the stock is held for the period under the law provided in the case of a long-term gain.

Page 78, line 7, we have a series of amendments relating to income from sources without the United States. The first amendment, page 78, line 9, subsection (a), proposes to strike out section 116 (a) of the present law under which earned income in the case of citizens of the United States who work in a foreign country more than 6 months during a taxable year is excluded from the gross income. The effect of the amendment is to include that amount in the gross income as being earned there.

The CHAIRMAN. Is that a Treasury recommendation, Mr. Paul?

Mr. PAUL. Yes; it is, Senator George.

Senator TAFT. What is the reason for it? I would think it would be a duplication, because certainly they are going to have to pay the other country on income earned in that other country.

Mr. PAUL. That is true. I think there were two underlying ideas in connection with that amendment. One was that the exemption in the existing law has been somewhat abused. There has been a great deal of avoidance of tax under it. There has been much juggling with the period of absence. And another thing, perhaps more important, is that a number of contractors are now making a considerable amount of money in Panama and some of those places—Bermuda and those places—and we feel that they should pay their taxes just like anyone else who is making the same money here in this country.

The CHAIRMAN. Well, now, would it be necessary to go all the way you have gone by eliminating that?

Mr. PAUL. They have a foreign tax credit, Senator George. If they pay income tax in this foreign state, they get relief under section 131 of the code.

The CHAIRMAN. I was just thinking of how it would affect us in the expansion of our trade and commerce in outside countries. If I were

a citizen who resided there, I would be at a pretty bad competitive disadvantage.

Mr. PAUL. There is that problem. We have to decide some of these things on balance. We thought on the whole it was an advisable amendment. It is true there are certain citizens, American citizens abroad, who will be put at some possible disadvantage, although they do have, as I said before, the foreign tax credit.

Mr. STAM. I might state on that particular amendment that the Ways and Means Committee itself felt that the amendment went too far, because it applied to the bona fide American citizens who had been residents in these countries for a number of years. The committee did instruct the Treasury and our staff to try to work out a provision to alleviate this situation. I think it is only fair to the Committee on Ways and Means to state that they were not in favor of an outright repeal of section 116 (a).

The CHAIRMAN. Without some saving clause.

Mr. STAM. Without some modification.

The CHAIRMAN. That is the way it occurs to me without studying it. I didn't know it was in there.

All right, Mr. O'Brien.

Mr. O'BRIEN. The next case relates to income from sources in possessions of the United States. There is included within the income which is subject to tax as though earned within the United States, all amounts paid by the United States or any agency thereof as compensation for labor or personal services or under any contract with the United States or any agency thereof. These amounts are added to the income which is subject to the American tax, notwithstanding the fact it is income from sources within a possession of the United States. The definition of "possessions," for the purpose of section 251, has been somewhat narrowed to include only the Philippines and Puerto Rico, to avoid any possibility of the Panama Canal Zone, American Samoa, the Virgin Islands, from being included—being given similar treatment.

Senator CLARK. Does this include the Philippines in its present form?

Mr. O'BRIEN. Yes; in its present form.

Senator CLARK. We had this up in regard to the Philippines a few years, in regard to which the American residents in the Philippines claimed that in many cases they were at a serious competitive disadvantage with American resident citizens in China and other places in the Far East, because the people in China and other Far East points didn't have to pay an income tax and that they did, and since they were in a competitive business they were at a serious disadvantage.

Mr. O'BRIEN. I think their complaint a number of years ago was based on the retroactive application of the tax to them.

Senator CLARK. That is true, but at the same time they represented that unless they were exempted they were at a serious disadvantage with Americans in China and other places.

Mr. O'BRIEN. This does not propose to change the law in that respect, except with respect to those amounts which they get from the United States, or get under contract with the United States. Those amounts are taxable even though received from sources within the

Philippines. Under the present law if you get more than 80 percent from the active conduct of a trade or business in the Philippines you are not subject to the American tax even though you are a citizen of the United States.

Page 79, line 13, allows the same treatment with respect to representatives of the Commonwealth of the Philippine Islands in the United States as is allowed in the case of foreign diplomats and counselor officials. Under the present law, a foreign diplomat who earns income in the United States from his salary is exempt from the Federal income tax if the foreign country allows a similar exemption with respect to our people doing the same thing in that foreign country. This proposes to extend that rule to the representatives of the Philippine Islands and to other employees of the Philippine Islands employed in that capacity if they do the same thing for us.

Page 31, line 12, relates to capital gains and losses. The first important change is to change the holding period, the period of differentiation between long-term and short-term losses from 18 months to 15 months. Long-term and short-term gains and losses, I should have said, are divided into two categories now instead of three categories under the present law. Up to 18 months is one group; between 18 months and 24 is another; and 24 up is the third. This proposes to divide them, making a dividing line between long-term and short-term of 15 months.

The second important change with respect to capital gain and loss treatment is to allow both short-term and long-term losses against short-term gains and long-term gains. Under the present law you have the allowance only of short-term losses against short-term gains or long-term losses against long-term gains. In the case of taxpayers other than corporations—that is, individuals, estates, or trusts—there is allowed to be deducted the excess of losses over gains to the extent of $1,000, or the net income, whichever is the smaller. The present 1-year capital loss—short-term capital loss—carry-over is eliminated and there is substituted therefor, applicable to all taxpayers, a 5-year carry-over of capital losses.

The final change in capital gain and loss treatment is to allow, in the case of a corporation and in the case of long-term capital gains, a maximum tax of 25 percent on long-term capital gains.

The CHAIRMAN. Do you have a 5-year carry-over in the case of a long term and short term?

Mr. O'BRIEN. Yes; a 5-year carry-over of the excess of losses over gains, Senator.

The CHAIRMAN. Losses over gains?

Mr. O'BRIEN. Yes.

The CHAIRMAN. Your short-term gains are still treated—they still go into your ordinary income?

Mr. O'BRIEN. Short term goes in at 100 percent.

The CHAIRMAN. In the ordinary income?

Mr. O'BRIEN. No losses are deductible against the short terms, of course, but if you have no losses, if you have no losses, that is true. The short-term gains go in 100 percent. Long-term gains go in at only 50 percent.

Senator TAFT. And the tax on the long-term gain is how much?

Mr. O'BRIEN. Twenty-five percent.

Senator TAFT. Twenty-five?

Mr. O'BRIEN. Yes.

Senator TAFT. Have you any figures to show how much money has been collected, how much money has been brought in by the capital-gains tax and how much money has been lost by the capital-loss provision during the last half dozen years?

The CHAIRMAN. Have you those figures, Mr. O'Donnell?

Mr. O'DONNELL. Yes, sir; I have a table of such estimates here. We can insert it in the record.

The CHAIRMAN. You can?

Mr. O'DONNELL. Yes, sir.

(The information requested is as follows:)

Individuals—Taxes on capital gains and losses, taxes on all other income, and total taxes, 1926–40

[In thousands of dollars]

Calendar year	Estimated taxes on capital gains and losses [1]	Estimated taxes on all other income	Total taxes [2]
1926	225,485	506,990	732,475
1927	296,879	533,760	830,639
1928	576,001	588,253	1,164,254
1929	420,971	580,967	1,001,938
1930	−15,226	491,941	476,715
1931	−80,001	325,128	246,127
1932	−79,917	409,879	329,962
1933	16,167	357,953	374,120
1934	17,197	494,203	511,400
1935	85,257	572,182	657,439
1936	201,941	1,012,076	1,214,017
1937	58,188	1,083,381	1,141,569
1938	52,878	712,960	765,833
1939	26,995	901,699	928,694
1940	12,868	1,481,271	1,494,139

[1] The tax on capital gains and losses is the difference between (1) the total tax under the provisions of the particular revenue act applicable to each specified income year, and (2) the total tax which would have been realized if capital gains and losses had been entirely excluded from the tax computation.

[2] Actual 1926 through 1940 (1940 preliminary). Data for 1937 and subsequent years include taxable fiduciary income-tax returns.

NOTE.—The above data are limited to income-tax returns taxable under the revenue acts in effect in the respective years.

Source: Treasury Department, Division of Research and Statistics, July 22, 1942.

The CHAIRMAN. We are not getting very much revenue out of the capital gains tax now, are we?

My general understanding is we get a very small amount; and I had hoped that when it got to the point where we are neither winning nor losing by it, we could experiment with it a little bit.

Mr. PAUL. It is not the revenue producer it used to be in the twenties, that is true. There is some revenue from it, and on balance over the years.

Senator TAFT. So many people seem to think the whole thing should be eliminated, and I wonder whether that is a sound view of it, whether at least it shouldn't be entirely separated from the income tax. I see a good deal desirable in permitting capital losses to be deducted from current income.

Mr. PAUL. That is one of the main changes, and is to prevent capital losses from being deducted from ordinary income.

Senator TAFT. This will no longer permit short-term capital losses to be deducted from ordinary income.

Mr. PAUL. That is right. On that point you asked about—I have here the figures on the estimated net revenue from capital gains and losses over a number of years. The figures are very high in the years 1926 to 1929, reaching a total of $120,000,000 in the year 1929. Then, for 3 years they were very small. There were very small revenue losses from the statute—that is, 1930, 1931, and 1932; and then we began to gain.

Senator TAFT. You say small losses. You mean small net losses?

Mr. PAUL. Small net losses. In other words, the losses exceed the gains.

Senator TAFT. Didn't they greatly exceed the gains in those years?

Mr. PAUL. The figures are: 1930, fifteen million; in 1931, eighty-nine million; in 1932, seventy-nine—practically eighty million, and then the tide turned.

Senator TAFT. You mean you actually lost revenue by having a capital gains tax at all in those 3 years?

Mr. PAUL. Yes; because the losses exceeded the gains. There was more revenue lost by the deduction of losses than by the taxation of gains. And then in 1933 the tide turned in a very small way until it built up to 1936, where the net revenue was two hundred million gain.

Senator TAFT. That was during the period when you were not allowing those losses from net income?

Mr. PAUL. That was true in 1934. There was a limitation. You could not deduct more than two thousand.

Then the revenue has been plus right along through 1940. I can insert these figures in the record: 1937, fifty-eight million; 1938, fifty-two million; 1939, twenty-six million; and in 1940, twelve million.

Senator TAFT. What would be the Treasury's thought in abandoning the tax altogether or at least filing it entirely separate?

Mr. PAUL. I think we will be opposed to that, for various reasons, one of which would be the tendency toward tax avoidance, and for various other reasons.

Senator TAFT. I understand that they have had it in England.

Mr. PAUL. Well, we could discuss that question at some length. They have a different conception of capital gain over there, but in general it is true and over in England a good deal of income tax is avoided by the absence of such a provision.

Mr. O'BRIEN. One other change on capital gains and losses.

The CHAIRMAN. Yes.

Mr. O'BRIEN. In the case of banks and life insurance companies, if their losses from sales or exchange of bonds exceed their gains from sales or exchanges of bonds, then all their transactions in bonds are not considered capital transactions; the result of which is to allow their excess losses against ordinary income.

The CHAIRMAN. All right. Where does that take you, Mr. O'Brien?

Mr. O'BRIEN. That takes us to page 92—I beg your pardon, page 90, line 1.

The CHAIRMAN. Ninety-two, line 1?

Mr. O'BRIEN. Page 90, line 1.

The CHAIRMAN. Page 90, line 1.

Now, what is the pleasure of the committee? Shall we go along longer today?

Senator CONNALLY. No.

The CHAIRMAN. Is it the pleasure of the committee then to return tomorrow, so that we may have Mr. O'Brien and the staff go over this bill with us at 10 o'clock?

Senator CONNALLY. Does the Chairman want to go on all day or just until noon?

The CHAIRMAN. I think we might finish by noon or 1 o'clock.

Senator CONNALLY. Until noon then, I am with you.

The CHAIRMAN. Before you go, gentlemen: Is it the pleasure of the committee to hold a Saturday session next week?

Senator CONNALLY. No.

The CHAIRMAN. Will it be agreeable to the committee if we undertake to close the Friday hearings about 1 o'clock on Friday rather than run the whole afternoon on Friday?

Senator CONNALLY. Yes.

The CHAIRMAN. Very well, we will meet regularly at 10 o'clock and try to conform to that general schedule.

(Whereupon, at 4:50 p. m., an adjournment was taken until 10 a. m., Friday, July 24, 1942.)

REVENUE ACT OF 1942

FRIDAY, JULY 24, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312 Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. Well, we might as well proceed. Mr. O'Brien, you might take up where you left off.

STATEMENT OF JOHN O'BRIEN, OFFICE OF LEGISLATIVE COUNSEL, UNITED STATES HOUSE OF REPRESENTATIVES—Resumed

Mr. O'BRIEN. The first section this morning begins on page 90, line 1. The first change is that real property improvements, buildings and so forth, are considered capital assets. Under the present law land is a capital asset, the building on it is not, when used in trade or business.

The CHAIRMAN. Does that apply to any ordinary buildings in connection with the business?

Mr. O'BRIEN. Yes; buildings used in trade or business.

The CHAIRMAN. Or a farm, for instance?

Mr. O'BRIEN. Yes.

The CHAIRMAN. That becomes a capital asset?

Mr. O'BRIEN. Yes; it was a capital asset up to the 1938 act, and in 1938 depreciable property was not considered a capital asset.

This goes back to the old rule in the case of buildings. Under the present law if you sell land with a building on it, the land is a capital asset and the building is not a capital asset.

The CHAIRMAN. All right.

Mr. O'BRIEN. The second major change relates to involuntary conversions of property (when property is condemned or destroyed by casualty). Where the gains from those involuntary conversions exceed the losses then all the transactions are considered capital transactions. If the losses exceed the gains, then none of the transactions is considered a capital transaction and the loss is allowed against ordinary income. The rule is applied in the case of a depreciable property and of capital assets held for more than 15 months.

Page 92, line 10 straightens out the law with respect to the holding period of stock acquired through the exercise of rights. It says when you exercise the right to subscribe for stock then that is the beginning of the holding period of the stock which you get as a consequence of the exercise of the right. The present law causes some administrative difficulties.

Page 92, line 21, extends the time during which the election may be made to treat the proceeds of Commodity Credit Corporation loans as income. The 1938 act allowed that election, but some people did not exercise the election. This gives them an opportunity, in connection with their return for the taxable year beginning in 1942, to elect to treat that amount as income.

Page 93, line 15, first extends the benefits of the amortization deduction for emergency facilities to taxpayers other than corporations; and, second, it extends the period of time during which the facility may have been completed back to January 1, 1940. The present law allows the deduction only if the facility was completed after June 10, 1940.

The CHAIRMAN. That was originally the provision in the Senate bill, was it not?

Mr. O'BRIEN. Yes.

The CHAIRMAN. Finally, it is about to get straightened out.

Mr. O'BRIEN. Page 100, line 15, and running over to page 102, line 7, allows a foreign tax credit to a domestic corporation on account of the tax paid by a foreign subsidiary of a foreign subsidiary of the domestic corporation.

Senator VANDENBERG. How is that?

Mr. O'BRIEN. Well, under the present law, a domestic corporation which has a foreign subsidiary gets credit for the foreign tax paid by the foreign subsidiary. This proposes to extend the rule down one more point in the chain, so that the domestic corporation can get a credit on account of the foreign tax paid by the foreign subsidiary of the foreign subsidiary of which the domestic corporation is the parent.

Senator VANDENBERG. I will talk that over Sunday at St. Elizabeths.

The CHAIRMAN. Does that mean a wholly owned subsidiary?

Mr. O'BRIEN. That means a wholly owned subsidiary; yes.

Page 102, line 19, provides for consolidated returns. The effect of this section is to permit corporations to file consolidated returns for corporation normal and surtax purposes.

Under the present law that is allowed only for excess-profit tax purposes. This provides if a corporation uses consolidated returns for one tax it must use consolidated returns for both. Under the present law the so-called Pan-American Trade Corporation and railroad corporations may file consolidated returns for the purpose of corporation normal and surtax. That privilege is still allowed those corporations, except that in the case of any corporation filing a consolidated return under the new provision the tax imposed by section 15 is increased by 2 percent of the consolidated corporation surtax net income of the group of corporations filing.

Senator GUFFEY. Mr. O'Brien, will that permit the newspaper publishers to file consolidated returns?

Mr. O'BRIEN. I think so if the requisite stock ownership is there. It is allowed to all corporations without any discrimination as to their character.

The CHAIRMAN. They are required to pay the 2 percent?

Mr. O'BRIEN. They are required to pay the 2 percent.

The CHAIRMAN. The 2 percent penalty for that privilege.

Senator GUFFEY. Then they can cover up the losses of one newspaper, like they did 2 years ago, is that right?

Mr. O'BRIEN. That is the effect of the consolidated return provision. You treat the whole group as one corporation. The losses of one offset the gains of another.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. The next change is page 108 line 22. Under the present law foreign corporations and nonresident aliens, if they have an office or place of business in the United States are taxed in the manner in which domestic corporations and citizens are taxed on income from United States sources.

Senator VANDENBERG. How is that?

Mr. O'BRIEN. Under the present law, foreign corporations and aliens which do business in the United States or have an office or place of business in the United States are taxed the way domestic corporations and citizens are taxed. This proposes that any foreign corporation or nonresident alien individual who merely has an office or place of business in the United States but does not do business in the United States shall be treated as foreigners.

Senator CONNALLY. What do they have an office here for if they do not do any business?

Mr. O'BRIEN. I understand that some of those people have offices here notwithstanding the fact that they are not doing business, just to get the benefit of our rate, which is more favorable in some cases. This constitutes the closing of a loophole.

Senator CONNALLY. Does it permit holding companies to make consolidated returns, too?

Mr. O'BRIEN. Yes; that is a typical case.

Mr. TARLEAU. That is a typical case, a holding company which has a consolidated subsidiary.

Senator GUFFEY. I think they should pay more than they have been paying. I am going to look into it. I am for more taxes.

Mr. O'BRIEN. Page 110 line 12 relates to pension trusts. That section has been substantially revamped. It relates to the employees' trusts which are exempt from taxation as a trust.

Senator CONNALLY. You are not talking about the congressional pension now, are you?

Mr. O'BRIEN. Not that pension, Senator. I do not think that was a trust.

Senator CONNALLY. It was a distrust.

Mr. O'BRIEN. It was a distrust; yes. Generally speaking, the section has been revamped to permit this tax exemption only in the case of nondiscriminatory trusts, that is where there is not discrimination in favor of the higher-priced employees and where the coverage is pretty extensive.

Senator TAFT. What does that exemption extend to? You mean they are exempt from paying taxes on their income?

Mr. O'BRIEN. It exempts completely the employees' pension trust if it is a good pension trust.

The CHAIRMAN. Is any limitation placed upon the amount of benefit that any one beneficiary might get?

Mr. O'BRIEN. No.

Mr. PAUL. That is not in this bill.

The CHAIRMAN. Was it rejected?

Mr. PAUL. There were difficulties about it.

The CHAIRMAN. Was it actually voted on?

Mr. PAUL. No; we did not press it, Mr. Chairman.

Senator VANDENBERG. Does the pension trust include profit-sharing plans?

Mr. O'BRIEN. Yes. When I say "pension trust," that mean a profit-sharing plan, annuity plan, stock-bonus plan. They are all in the same picture.

Senator CONNALLY. This just exempts the trusts?

Mr. O'BRIEN. This just exempts the trusts.

Senator CONNALLY. It does not exempt the pensions?

Mr. O'BRIEN. No; it also allows a deduction to the employer on account of the payment into the pension fund of an amount not in excess of 5 percent of the compensation. The remainder over 5 percent may be spread over a period of 60 calendar months and deductible after the payment is made, somewhat similar to the present law.

Senator TAFT. Has there been some abuse in the exemption of the pension trust? Offhand I do not see why they should be taxable at all. It seems to me an indirect method of paying wages of employees. When employees get the money I think they should pay the income tax, but why should the trust be taxable at all? Has there been some abuse of it.

Mr. O'BRIEN. I understand there has been some abuse of it, particularly in some cases in which the attempt has been made really to pay additional compensation to the higher-priced employees. Actually that is a way of paying a salary to an employee. Under the present law, some of those trusts are exempt.

Senator TAFT. Of course, when the fellow actually gets the money, he has to pay on the income. He cannot avoid it that way.

Mr. O'BRIEN. That is true. That constitutes a postponement. Giving deductions to an employer in the current year constitutes a postponement of income tax.

Senator TAFT. A postponement for a time until he gets the money.

Mr. O'BRIEN. Take the $100,000 man and you want to pay him $150,000, you pay him a salary of $100,000 and put $50,000 in the pension trust, and then when he does actually get the $50,000, he is not in as high a bracket as he would be if he got the $150,000 in the current year. I understand there have been some abuses in connection with it.

Senator TAFT. Suppose he made a contract to pay him $150,000 after he retired, that would not be a tax exemption. He would pay it when he got it.

Mr. O'BRIEN. Yes; he would pay it when he got it.

Senator TAFT. How does the pension trust differ from that?

Mr. O'BRIEN. It does not differ in the sense that they postpone compensation.

Mr. PAUL. It is different in the sense that they do not get the extra deduction, Senator. The vice is that the corporation immediately gets a deduction against its higher rate of tax. The employee, frequently an officer or key employee, does not pay any tax on that which is allowed as the deduction to the corporation, and then many years hence, I might say a good many years, when the employee retires and when his bracket is much lower because he is not getting his ordinary salary,

the amount given to him is not superimposed over his salary. He gets the amount paid out of the pension trust, and so that amount is taxed at a very much lower rate.

Senator TAFT. The Government does not get it, but I do not see how anybody suffers from it.

Mr. PAUL. The Government suffers very decidedly in two ways.

Senator TAFT. I do not see what difference it makes. The Government gets the tax when the people get the income.

Mr. PAUL. The money is paid out of the corporation and therefore is not taxed to the corporation because it is deducted by it.

Senator TAFT. I understand. Nobody gets that money. That is the substance of it.

Mr. PAUL. That goes into the trust for the benefit of the employee. Under the present law there is no tax on it. Neither the trust is taxed nor the employee is taxed until it is paid out.

Senator TAFT. This way you get it twice. It is taxed when it goes to the pension, and you get it once more when it goes to the employee.

Mr. PAUL. We are not abolishing pension trusts at all, Senator.

Senator TAFT. You are taxing them when it is paid into the trust and you are taxing them when it goes to the employees.

Mr. PAUL. Not at all. We are simply asking that trusts be more bona fide and non-tax-avoiding if they are going to get the benefit of the statute. We are not changing the rule with regard to pension trusts at all, only the rules as to which trust will qualify to get the benefit of the statute.

Senator TAFT. What are those qualifications, the new ones?

Mr. O'BRIEN. Beginning on page 111, line 16, 70 percent or more of all the employees, except part-time employees and except casual employees, must be eligible. In the alternative, the scheme must be under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of officers, shareholders, or highly priced employees.

Senator TAFT. Are those the only qualifications?

Mr. O'BRIEN. Then there are some qualifications the same as under the present law, for instance, that it is impossible for any part of the corpus or income of the trust to revert back to the employer.

Senator TAFT. What about that provision? How can you get rid of that possibility in the pension trust? Supposing a corporation was finally dissolved, what happens to the money that is left?

Mr. O'BRIEN. What happens to the money that is left?

Senator TAFT. Yes.

Mr. O'BRIEN. Theoretically, there should not be any money left at all.

Senator TAFT. I do not know about that. Naturally, with a pension trust you want to build up a big enough reserve to be sure the fellow is going to get the pension that you agreed to pay. You probably have an excess, and therefore you probably have reserves of some kind. What happens to those reserves? I can see why they should be taxed to somebody sometime, but I do not see why the whole trust should be disqualified because they have common sense enough to accumulate a reserve that might conceivably go back to the corporation.

Mr. O'BRIEN. In that case the amount would go to the employee. That is the employee's amount.

Senator TAFT. Suppose the employees died? The question is whether you can make a provision by which you can find people to pay that excess to.

Mr. O'BRIEN. The law says it has to go to the employee, it cannot go back to the employer.

Mr. PAUL. If the corporation is to get the benefit of the deduction it must be an unqualified payment. In the case you cite, a corporation dissolving, the trust would presumably either be dissolved also or continue for the benefit of the employees because the money is not money of the dissolved corporation.

Senator TAFT. Yes; but your qualifications about life extension may be wrong. If you guarantee to your employees 4 percent you are taking an awful chance, so you naturally want a reserve, and a reserve is built up which probably, in the natural course of events, never may go to the corporation, probably will go on forever.

Mr. PAUL. That is right.

Senator TAFT. Supposing something did happen and it was a contingency under which it might go back to the corporation, then under this, as I understand it, the whole thing would be taxable at once.

Mr. PAUL. That is one of the qualifications in the existing law. That is not changed. We are not making any change in that requirement.

One of the requirements in the present law and regulations is that the trust be put on a sound actuarial basis.

Senator CONNALLY. Mr. Paul, let me ask you a question. As I understand it, your theory is when this goes into the trust, it is in the trust and it cannot revert back to the corporation?

Mr. PAUL. That is right.

Senator CONNALLY. And because it is not permitted to go back to the corporation, it will be utilized as a device all the time.

Mr. PAUL. Not only that but the corporation would be getting the benefit of the deduction.

Senator CONNALLY. In the case of dissolution, it would be a matter for a court of equity to decide. I found lots of them that have not got pensions and that want pensions. You will not have any trouble in finding somebody that will take the pension. If there were any pensioners that could not be found, it would be different, but they would be found. I can furnish a good many, if you want any.

Mr. PAUL. As a matter of fact, they are provided for usually in the instrument.

The CHAIRMAN. A trust would hardly be approved that did not provide for contingencies, would it, as a fair trust?

Mr. PAUL. Well, there is not any requirement in the law specifically requiring that there be a provision for distribution on dissolution, but there is a requirement negatively that it cannot come back to the corporation.

The CHAIRMAN. That is what I mean.

Senator TAFT. I just have difficulty in seeing how you can draw up a pension trust that, under some circumstances, something might not come back to the stockholders of the corporation.

Mr. PAUL. It can be done and has been done very extensively.

That, however, is not a change in the law. I want to make that clear. It was adopted, I think, in 1939.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. The next change begins on page 119, line 7 and relates to life-insurance companies. The definition of life-insurance companies has been changed slightly, and in lieu of a deduction of 3¾ percent of the mean of the reserve funds required by law, and in lieu of the double deduction, what is, in effect, a double deduction for the partially tax-free interest, and tax-free interest there has been substituted a new deduction which is called the "reserve and other policy liability credit."

I do not know how deeply you want to go into this. I am not sure that I can go all over it, but that is roughly what is the change.

The change in the definition of life-insurance companies is to exclude the so-called burial- and funeral-benefit companies and to include within life-insurance companies certain companies to the extent of their business on noncancelable health and accident policies.

Senator CONNALLY. Then would the burial and funeral life-insurance companies be taxable here?

Mr. O'BRIEN. They would be taxed as ordinary corporations, not as insurance companies.

The CHAIRMAN. If this definition remains in. That question has already arisen, I presume.

Mr. TARLEAU (Thomas Tarleau, Legislative Counsel, Treasury Department). It has been called to our attention by some of these burial and funeral companies, that there is a great deal of variance among several States as to how they are conducted. Some of them are conducted, from information given to us, on a system that is quite similar to that of insurance companies, and others are conducted very much like an ordinary corporation; they just make an arrangement to sell their goods and services, namely, a casket, the funeral, and so on.

At the moment we are going into the problem of seeing how we may adequately take care of the burial and funeral companies that operate very much like insurance companies that have reserve funds.

The chairman asked us to see some people from one of the States yesterday, and we are actively working with them this morning.

Senator CONNALLY. As a rule do the States have pretty stringent laws in regard to insurance companies? My conception is a lot of those concerns are rackets.

Mr. TARLEAU. The information given to us that a great many of them are not actually insurance companies at all but are companies engaged in the manufacture of caskets; and, in order to sell their caskets, they make an arrangement with future clients of theirs during their lifetime to get those caskets when they die.

Of course, it is that type of company that we want to exclude from the provisions of this insurance-company section. On the other hand, we were told yesterday that in the State of Alabama the State law provides for the supervision of those companies under the insurance laws, and consequently the situation there may be quite different.

The CHAIRMAN. Yes; some operate on the same basis as these industrial insurance companies, but the benefits are payable in specifics rather than money.

Mr. TARLEAU. Yes.

The CHAIRMAN. That would seem to be the only difference.

Senator VANDENBERG. This section does not deal with insurance deductions of the individual taxpayers?

Mr. O'BRIEN. No; just the taxation of the companies themselves.

Senator TAFT. If this plan works out, does it meet with the general approval of the insurance companies?

Mr. PAUL. This provision has been worked out in concert with the insurance companies, the two main associations representing the life insurance companies and several independent companies that were not in the associations. The Treasury put up another proposal which we thought was a satisfactory solution of the problem.

The insurance companies protested, not on the ground of the amount of the tax which it called for, but rather the distribution of that tax load among the companies. The companies thereupon, made a counter proposal, which is the one incorporated in the statute which they said, and passed resolutions to the effect that it was satisfactory to them, and that is what is in the statue.

Senator TAFT. We are not likely to have any protest on this?

Mr. PAUL. None whatever.

Senator TAFT. What about the question of mutuals?

Mr. PAUL. We will come to that next.

You mean mutual other than life?

Senator TAFT. Yes.

Mr. PAUL. We have another provision about that.

Senator VANDENBERG. How much more do you take out of life insurance companies?

Mr. PAUL. A little over $26,000,000.

Senator VANDENBERG. And you are all agreed on it?

Mr. PAUL. In complete agreement.

Senator VANDENBERG. I think we ought to have a recess and a little drink.

Mr. PAUL. I might say, I would like to put it on the record that the insurance companies cooperated very faithfully with us. It was a hard job to get this thing worked out.

The CHAIRMAN. Go ahead, Mr. O'Brien.

Mr. O'BRIEN. The next subject is the insurance companies other than life or mutual. That is the stock fire companies and stock casualty companies.

To the extent that they partake of the character of mutual companies, they are permitted deductions somewhat similar to mutual companies by the change made in this provision.

The next subject is on page 130, line 17, mutual insurance companies other than life. The exemption provision relating to mutual insurance companies other than life—and that is mutual casualty and fire insurance companies—has been changed so that only those companies are exempt the mean of the ledger assets of which do not exceed $100,000.

Furthermore, if their surtax net income does not exceed $50,000, they are not subject to tax. Other substantial changes have been made in the case of these mutual insurance companies other than life, the effect of which is to put them on substantially the same basis of taxation as stock companies doing the same business.

Senator VANDENBERG. Do they agree to that?

Mr. TARLEAU. You can divide the mutual insurance companies other than life into the farmers type of small mutual company and the larger mutual company that is in competition with the stock com-

panies, like the Lumbermen's and other types of large million-dollar concerns. The small farmers' mutual companies have passed resolutions in most of the Midwestern States, which I am prepared to supply to the committee, in which they have stated that they are satisfied with the Treasury amendment.

I think in the case of one or two of them, I believe in Iowa and Illinois, the State Grange, which runs these small farmers companies, stated that they would actively support the Treasury proposal, but that deals with the farmers' type, the local type, of mutual company.

The large mutual company that does a large business throughout the State like the Lumbermen's and the Liberty Mutual are not satisfied with the treatment because they feel the very fact that they are mutual companies gives them a status that is different from that which they are accorded under this bill.

In this bill, as Mr. O'Brien will explain to you, we tried to put these companies more in line with the treatment that we give to stock companies. The very fact that they are mutual companies makes an exact correspondence impossible, but there has been a wide discrepancy between the tax paid by the million-dollar or two-million-dollar mutual type company and the stock type company.

What we have done is to pretty generally exempt from taxation the farmers' type of local mutual company in which the mutual element is extremely great, run by the farmers themselves, or run by the State Grange, and things of that sort.

But the ordinary type of large mutual company that is in active competition with the stock companies, will stand more nearly in the position of the stock company.

Senator RADCLIFFE. In any instance, the income comes from the same source, it comes from the premiums paid.

Certainly, there does not seem to be any reason why there should be any exception.

Senator GERRY. Why was it made $100,000? Was there any special reason for that?

Mr. TARLEAU. No. The exemption provision says, "if the mean of the ledger asset held at the beginning and end of the taxable year does not exceed $100,000."

Either one of two tests qualifies you as an exempt mutual company. If your income is less than $50,000—which eliminates practically all of the farmers' type of companies—then you are out, or even if your income is in excess of $50,000, if the mean of your ledger asset does not exceed $100,000, then you are out.

If for some reason, in 1 year they go up to $60,000, if they are still a small company because their assets are small, they are still exempt.

Senator GUFFEY. Did I understand you to say the farmers are satisfied?

Mr. TARLEAU. Yes, sir.

Senator GUFFEY. I am glad to hear that.

The CHAIRMAN. What is the estimated increase in revenue?

Mr. PAUL. Just short of $10,000,000 a year.

Senator RADCLIFFE. I understand there is no distinction, except the $2,000 that has been mentioned, as to the amount of reserve. I mean, you have no exemption based on the character of the business.

Mr. PAUL. No; those two exemptions are designed to clear out of the picture a lot of the small farmers' type of real mutual company.

Senator CONNALLY. Has not that been more or less your theoretical test, that the real mutuals were these little concerns and a few large ones were utilizing this exemption to do business pracically on the same basis as the old line companies and get the advantage of not paying any tax, thereby competing and being able to give their officers a bigger slice of salary?

Mr. PAUL. I do not know about the last conclusion, but certainly section 101 (11) when it was originally passed was designed to protect the small type of company. It gradually worked out so the large company has been able to compete in what we think is an unfair way with the stock company.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 139, line 13, is a purely technical change relating to the taxation of nonresident alien individuals, and so forth.

Under the present law, such people are exempt from the tax on the gain on sales on commodity exchanges. This amendment is designed to close the loophole where they are dealing in commodities not on exchanges.

Such dealing is subject to tax and is not exempt from the tax in connection with capital gains.

Page 140, line 4 makes numerous technical changes in the statute of limitations on refunds and credits. What it is designed to do is to equalize the situation with respect to the statute of limitations in the case of taxpayers and in the case of the Commissioner, particularly in cases in which, for instance, the taxpayer has filed a waiver of assessment and collection of the tax. I do not think I need to go into this section because it is constantly being revised as new things come up.

The next change relates to the taxes on regulated investment companies, page 146, line 5.

The most substantial change is to tax the so-called closed-end companies under this supplement, the same as open-end companies are now taxed. The present tax is a kind of undistributed profits tax and only those companies are eligible which permit a redemption of their stock under certain conditions.

The whole section has been broadened to bring the taxation treatment more nearly in line with their regulation by the Securities and Exchange Commission.

Senator CONNALLY. This relates to investment trusts. Every time we have a tax bill, we are mixed up with them.

Mr. O'BRIEN. That old row has been finally settled by permitting the closed-end companies to have the same treatment as the open-end companies.

The CHAIRMAN. I need not ask whether they have all agreed to this treatment.

Mr. PAUL. That is unnecessary and I might add the Securities and Exchange Commission has approved it, too.

The CHAIRMAN. It is in line with the recommendations they previously made.

Mr. PAUL. That is right, sir.

Mr. O'BRIEN. The next subject is on page 158, line 23, and that is the collection of tax at the source, the so-called withholding provi-

sion. If you do not mind, I should like to have you postpone consideration of that until I can get Mr. Rice, because Mr. Rice wrote this and is more familiar with it than I am.

The CHAIRMAN. What page?

Mr. O'BRIEN. Page 158, line 23, and it runs over to page 181, line 6.

I ask that you postpone that until Mr. Rice comes. He happens to be at another committee meeting just now.

I have passed over one important change, page 152, line 14, amendments to supplement R. Supplement R is the supplement under the present law which permits the receipt of property without the recognition of gain by a public-utility company when it is required by the Securities and Exchange Commission to integrate its system under the Public Utility Holding Company Act of 1935.

Under the present law those transfers, in pursuance of the orders of the Securities and Exchange Commission, are tax exempt.

This proposes to broaden the treatment so that notwithstanding the fact that the public utility holding company may get some property which is subject to the tax, that is so-called nonexempt property, this says if they take such nonexempt property and within 24 months convert it into exempt property, that is, they take the money and buy, say, an electric plant with it; then the gain is still not recognized on account of the earlier transaction, but the amount of the gain which would be recognized is applied in reduction of the basis for determining gain or loss on all of the remaining properties of the company.

Senator CONNALLY. Would this cover a case like this—I had that up some time ago—there was a project for a big self-liquidating municipal plant. The city of Beaumont, I think it was, was going to get a great loan from the Government and build a water supply. The local company that owned the water was also owned by the utility. One of the conditions of the loan was they must get the local utility out, they must buy their water plant. In the process of going through all this, the local company was perfectly willing to sell the water plant, exchange it for a gas plant.

Well, if they did that under the existing law, they would have to pay a tremendous tax on the exchange for the gas plant, because they are only allowed to buy another electric plant, the same business that they are in. It was blocking the whole deal. They were perfectly willing to take the gas plant, but they could not do it under the law.

Would that cover this?

Mr. O'BRIEN. Not unless they were required to get the gas plant in pursuance of an order of the Securities and Exchange Commission. This relates only to the integration of those systems under the Public Utility Holding Company Act of 1935.

Senator CONNALLY. This company was going through that process.

Mr. O'BRIEN. They are all right then.

Senator CONNALLY. But they would not be required to divest themselves, by the Securities and Exchange Commission, of the water plant. They are willing to do it in order to let this deal go through, but if they made the trade for the gas plant instead of for the water plant, it would be such a prohibitive tax that it would take all the holdings, and they would not do it.

I will talk with you later on that. I had them contact the Treasury about it. I do not know what they ever did about it.

Mr. O'BRIEN. Passing over the collection of the tax at the source, which Mr. Rice is to touch on, I will next turn to page 181, line 7, which relates to personal holding companies.

The first change is to raise the rate of tax on personal holding companies. Under the present law the rate is 71½ percent on the first $2,000 and 82½ percent on the remainder. Those rates have been raised to 75 percent on the first $2,000 and 85 percent on the remainder.

The next change in personal holding companies is on page 182, line 14, which has the effect of exempting from the personal holding company tax certain loan and investment corporations subject to supervision by State authority, a substantial part of the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment.

I understand there are such regulated companies throughout the States. This proposes to give them the same exemption as in the case of licensed finance companies. This provision is made retroactive to the taxable years beginning after December 31, 1938, that is, 1939, 1940, and 1941.

Senator TAFT. Does this meet the objection that we hear all the time by the personal finance companies? There are quite a few in Ohio. They have been here every year for the last 4 years.

Mr. TARLEAU. I think they were Indiana companies that came in to see us, but I think the situation is pretty well the same in Indiana as in Ohio.

Mr. O'BRIEN. The next change is on page 183, line 6.

Under the present law, a personal holding company and railroad corporations are permitted to file consolidated returns. This proposes to confine that privilege to personal holding companies and railroads and not to extend the privilege to all personal holding companies and other types of companies.

Page 183, line 19, is a purely technical amendment relating to deficiency dividends. Those are dividends which a personal holding company is permitted to pay after it has received the notice of deficiency and thus get credit. It is permitted to pay the money to the stockholders. The stockholders pay the tax and the personal holding company gets out of the tax.

By reason of the increase in rate from 65 to 71½ and from 71½ to 75, and on up, for the various years with respect to which the deficiency dividend credits are allowed, those rates are raised here accordingly.

On page 184, line 12, begins a series of amendments relating to distribution by personal holding companies. Under the present law, by reason of the fact that a dividends-paid credit is only allowed for dividends paid out of earnings and profit, there have been situations arising in which a corporation has distributed all its income but has not been able to get a credit for distributions, because the distributions were not out of earnings and profits. The net income, in other words, was greater than earnings and profits.

Distributions not in liquidation, even though not out of earnings and profits, will constitute dividends and hence the corporation gets a dividends-paid credit for it, and the shareholders will pay tax on those dividends under the proposed change.

Those provisions are made retroactive back to 1936.

The next series of changes relates to excess-profits tax and begins on page 194, line 14.

Senator VANDENBERG. Have you made any change anywhere here, or are you familiar with the deduction of the expense in hiring counsel and corporation tax attorneys?

Mr. O'BRIEN. No. On page 194, line 14, begins the excess-profits tax.

The amendments made by this title are applicable only to taxable years beginning after December 31, 1941, except where otherwise noted.

The next section, section 202, raises the rate of excess-profits tax from a graduated rate beginning at 35 percent and a top rate of 60 percent to a flat 90 percent.

Senator CONNALLY. The bill has changed the definition of "excess profits"?

Mr. O'BRIEN. No; the average earnings and invested capital credits are still retained, Senator. There have been some changes, but the basic theory of the excess-profits tax has not changed.

Senator BROWN. That leaves the option in?

Mr. O'BRIEN. The option still exists; yes.

On page 195, line 3, the present specific exemption of $5,000 from excess-profits tax is raised to $10,000. Correspondingly, the mutual insurance companies other than life have a specific exemption of $50,000, because they have, in effect, a specific exemption of $50,000 from normal tax and corporation surtax.

Page 195, line 15 relates to the invested capital of insurance companies, the most important provision is that the reserves of an insurance company are not included in computing equity invested capital but are treated as borrowed capital.

Page 197, line 11 makes numerous technical amendments to the excess-profits tax, made necessary by reason of the change in the method of computing the normal tax. As I mentioned yesterday, instead of taking excess-profits tax as a deduction for the purpose of computing the normal tax, a corporation is allowed a credit on account of the amount which is subject to the excess-profits tax. These are technical amendments to carry out that policy.

There is one other provision on page 198, line 19, the excess-profits credit carry-over. For the purpose of the excess-profits carry-over, the excess-profits credit and the excess-profits net income for any taxable year beginning in 1940 or 1941 is computed under the law applicable to taxable years beginning in 1942. That is carrying forward the policy that you had in the last amendment to the excess-profits tax.

Page 199, line 3 makes necessary changes in the capital gains and losses treatment by reason of the change in capital gains and losses in the basic income tax, the change from 18 to 15 months, and so forth.

Page 200, line 21, section 207, applies in the case of the excess-profits tax, the same rule to corporations having an office or place of business in the United States as is applicable for the purposes of the normal tax and corporation surtax.

Page 201, line 9 provides a rule for putting the excess-profits net income of a corporation having a short taxable year on an annual basis. The rule is substantially similar to the one which I explained yesterday in connection with the ordinary normal and corporation surtax.

Senator BROWN. Mr. O'Brien, I want to ask a question that is not exactly in point but this section 208 reminds me of it.

Through the action of the Supreme Court in declaring the processing tax of 1934 to be invalid, a great many companies will pay in 1942 and probably in 1943 on any refund of those taxes. Will they be taxed under the 1934 rates or under the 1942 and 1943 rates?

Mr. O'BRIEN. The 1942 and 1943 rates.

Senator BROWN. What justification is there in that?

Mr. O'BRIEN. I do not know.

Senator CONNALLY. Did they take a deduction for the tax when they paid it?

Senator BROWN. I presume they did.

Mr. O'BRIEN. Those amounts are not included in excess-profits net income, Senator. They are specifically excluded.

Senator BROWN. Your previous law did that?

Mr. O'BRIEN. Yes.

Senator BROWN. I am fully satisfied that that does it.

Mr. O'BRIEN. Page 203, line 22, section 209 makes a purely technical amendment to the definition of "deficit" in excess-profits net income. The major effect of it is to say if a corporation has income from partially tax-exempt interest that income is used for the purpose of ascertaining whether or not it did actually have a deficit.

Under the present law the excess of your deductions over gross income establishes the deficit for excess-profits tax purposes. This says that you add back the partially tax-exempt interest for the purpose of ascertaining whether or not you do have a true deficit.

Senator CONNALLY. For instance, that is taking the Federal obligation that is taxable only on the surtax, is that right?

Mr. O'BRIEN. Yes; you include that interest for the purpose of ascertaining really whether the fellow has had a loss.

The next section, section 210, capital reduction in case of members of controlled group, relates to the adjustments in capital in the case of average earnings corporations and is an attempt to take care of a case in which there is a split-up of an average earnings corporation into two corporations.

This says that you make adjustments in the capital of the parent corporation on account of the split-off of the subsidiary corporation from the parent.

Senator DANAHER. Mr. Chairman, a question.

The CHAIRMAN. Senator Danaher.

Senator DANAHER. Is there a definition in existing law of what is meant by the term in line 21 "the same controlled group"?

Mr. O'BRIEN. "The same controlled group"?

Senator DANAHER. Yes; on page 204.

Mr. O'BRIEN. No. The definition for this purpose is on page 206, line 3, Senator, "As used in this paragraph, a controlled group means one or more chains of corporations," and so forth.

The next change is on page 206, line 18, relating to the invested capital credit. Under the present law the invested capital credit is 8 percent of the invested capital not over $5,000,000 and 7 percent on the invested capital over $5,000,000. Those two brackets have been retained, and two additional brackets have been added. If the invested capital is over $10,000,000 but not over $200,000,000, then the invested capital

credit is $750,000 plus 6 percent of the excess over $10,000,000. And there is allowed as an invested capital credit 5 percent on any excess over $200,000,000.

Senator DANAHER. Mr. O'Brien, before you get into a new topic, referring to that definition on page 206 that you mentioned, starting in line 3, is there any distinction between the definition of "controlled group" therein appearing, and cases where a given subsidiary corporation is necessary to carry on the business of the parent corporation?

Mr. O'BRIEN. I am afraid I do not quite understand you.

Senator DANAHER. There could be easily a controlled group in the sense that the parent corporation will hold 50 percent or more of the stock of a good many owned corporations, but the latter would not necessarily be engaged in effectuating the business of the parent corporation.

Is there any distinction between corporations that are necessary to carry on the business of the parent corporation and those that are not?

Mr. O'BRIEN. No; this is not geared on their business relationships; it is just stockholding. If you have more than 50 percent of the stock, then that corporation is a member of the group that you control. It is not geared to what kind of business it is engaged in.

Senator DANAHER. Or even the necessity for the subsidiary does not enter into it?

Mr. O'BRIEN. No; that has nothing to do with it.

Senator DANAHER. The sole base is the ownership of the stock?

Mr. O'BRIEN. That is right.

Senator TAFT. Mr. Paul, what is the exact justification for reducing the percentage of invested capital in the case of corporations over $10,000,000? I see some reason for reversing the invested capital now, but it seems to me once a corporation gets to be a $5,000,000 corporation, it is about as big as most of corporations of that kind get.

I do not see why everything over that should not be pretty much the same. There is some reason for the scale of rates in corporations up to $1,000,000, but I do not see why a corporation which has an invested capital of $200,000,000 should be treated differently than a $5,000,000 or a $10,000,000 corporation.

Mr. PAUL. While I am in sympathy with that change, I think I should pass that question to Mr. Stam, since he is the original inventor of that change.

The CHAIRMAN. Mr. Stam.

Senator TAFT. It would affect the stockholders more than anybody else in the corporation.

Mr. STAM. The only question involved here is that a lot of the large corporations have never earned, at least for a long period of time, as much as 8 or 7 percent on their invested capital. A lot of them have been earning but 2 or 3 percent. Our studies indicated that at least so far as the net income corporations were concerned, the return on the invested capital was less with respect to the larger invested capital corporations than with respect to the smaller corporations.

Senator TAFT. I can see some reason to scale that up to $5,000,000 or $10,000,000, but I do not see any reason for going from $10,000,000 to $200,000,000.

Mr. STAM. Many corporations above $200,000,000 do not earn over 5 percent on their invested capital.

Senator TAFT. A lot of the little ones do not either.

Mr. STAM. A lot of the little ones did earn more than 5 percent, and that is why we made the arbitrary rule. We did not want to hurt the corporations that had been able to earn 8 percent. But those corporations which had never earned as much as 8 percent—and now you are giving them a credit of 8 or 7 or some other percent—will not pay any excess-profits tax.

Senator TAFT. I understand that. That is a perfectly good reason for reducing everybody to 5 percent. I think the whole principle of graduating the percentages on corporations is doubtful, except as you might regard it as a kind of a bonus for what you might call small business, which certainly would be under $5,000,000. Otherwise I do not see any basis for graduating the thing.

Your argument is a perfectly good argument for reducing it from 8 to 5 percent, which I think should be done, but I do not see the reason for graduating it.

Mr. STAM. If you reduce it to 5 percent you would be doing a lot of harm to small corporations that had been making a return of 8 percent on their invested capital in back years.

Senator TAFT. They would just shift over to the average-earnings basis.

Mr. STAM. We do not look altogether at the average-earnings years because a lot of these corporations did not make a very high return in the base period and therefore they cannot use the average-earnings credit, but when you look over a long period of time you will find that a lot of these corporations have been making as much as 7 percent, and some of them as much as 8 percent.

Senator TAFT. Why would it be more of a hardship on a $5,000,000 corporation than on a $200,000,000 corporation?

Senator CONNALLY. May I interrupt you there?

Senator TAFT. Yes.

Senator CONNALLY. According to your theory, there ought to be some relationship between the tax and what they had been formerly earning?

Mr. STAM. That is right.

Senator CONNALLY. Therefore, if you make it 5 percent you are taxing the little companies on the theory of excess profits at a much higher rate than you would be taxing the big companies who have not been making, theoretically, at least, as high a percentage of income as the little ones?

Mr. STAM. That is right.

Senator CONNALLY. That is your theory?

Mr. STAM. That is right.

Senator CONNALLY. And being an excess-profits tax, there must be some relationship.

Senator TAFT. I do not see any relationship between the graduated rates and what they happened to be earning. Any corporations over $5,000,000 that may have been earning 2 percent are mostly the capital-goods corporations. You can have a pretty good-sized corporation on the capital of $5,000,000.

Mr. STAM. That is true. But, as I say, the excess-profits tax is imposed on the theory that we are taxing the excess over what they had been earning.

Senator TAFT. No. This tax is imposed on the theory that a man should be entitled to earn a certain percentage on money that he has invested, regardless of the earnings.

Mr. STAM. I do not think so. Suppose he never has, over a long period of time, earned more than 2 or 3 percent on his invested capital, it does not seem to me, in a time like this when you are trying to raise all the revenue you can, that you can say to that corporation that never has earned more than 2 or 3 percent on its invested capital that "we will allow you 6 or 8 or 7 percent before the excess-profits tax applies."

Senator TAFT. That is an argument against putting in this alternative.

Mr. STAM. No.

Senator TAFT. Certainly that is an argument for eliminating this alternative. It is not an argument for graduating the scale between corporations of $5,000,000 and corporations of $200,000,000. What is the difference between a corporation of $5,000,000 and one of $200,000,000?

Mr. STAM. The only difference is this: That, by and large, corporations of $200,000,000 or over do not earn as much as 7 or 8 percent on their invested capital.

Senator TAFT. I think that is a rather violent assumption. I do not know. The figures may show that. It may be true. I think the distinction is not between the size but between those that require very large capital for operation and those that have a small capital for operation.

Mr. STAM. We had some cases where the corporations had as high an invested capital as $2,000,000,000 and they did not earn anything like 8 or 7 percent on that $2,000,000,000; they earned 2 or 3 percent. We felt 5 percent was a rather fair return to allow those large corporations.

Senator TAFT. Let me put it this way: If a stockholder in a corporation of $10,000,000 that has never earned but 2 percent is entitled, before he pays excess profits, to get 7 percent on that money that he put in the business, why should not a stockholder who has put his money in a $200,000,000 corporation get the same?

Mr. STAM. The way this works is that on the first $5,000,000 of the invested capital we allowed 8 percent. In other words, the stockholder in the large corporation is going to be allowed 8 percent on the first $5,000,000.

In other words, it is not going to be taken away from the large corporation.

Senator TAFT. That represents 1 percent of what he had put in the business. That does not help him any.

Mr. STAM. Then the large corporation with an invested capital of between $5,000,000 and $10,000,000 is going to be allowed 7 percent on the excess over $5,000,000.

Every corporation is treated alike under this rule. In other words, up to the first $5,000,000 it does not make any difference whether it is in a large corporation or whether it is in a small corporation, they are going to be allowed 8 percent, and between $5,000,000 and $10,000,000 they are going to be allowed 7 percent.

Senator TAFT. I cannot understand the basis of distinguishing between the stockholder in a $5,000,000 corporation and a stockholder in a $200,000,000 corporation. They are both in companies that may have earned 2 percent. I see a reason for reducing them all to 5 percent; I have no objection to that, but I cannot see the basis for the graduation.

Senator RADCLIFFE. Mr. Stam, in giving your experience in regard to big companies and small companies, and also considering it from the standpoint of contrast, have you prepared any figures showing the percentages in cases of that sort, or have you relied more or less on general impressions?

Mr. STAM. We have some general statistics that we have gotten up showing the different relationships in regard to the net income of the companies.

Senator RADCLIFFE. I think it might be interesting to see what those figures are, the relative experiences of the small companies and the large companies.

Mr. STAM. I want to make this clear: We are not denying the large company the credit that the smaller company gets on the first $5,000,000 of its invested capital.

Senator RADCLIFFE. That is brought out very clearly in your statement.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 207, line 1 relates to the amount which is included in invested capital on account of property which is paid in for stock. This says if the property which was paid in for stock was disposed of before the taxable year, then its basis shall be determined in accordance with the law applicable to the taxable year when it was disposed of.

Under the present law the concept is you still hold the property, that is, you determine its basis in accordance with the law now in effect.

Page 207, line 15 contains the so-called relief provisions.

I do not think it is possible really to summarize them. They have to be read. In certain circumstance where it can be shown that the average earnings credit of a corporation is too low, then the Commissioner or the Board of Tax Appeals, as the case may be, will construct a fair and just constructive average base period net income for the purposes of that corporation. That summarizes it very briefly, but there is no way to cover it except to just read the whole thing all the way through to get it.

Senator CONNALLY. Have you laid down any standards that they should follow in doing it, or is it arbitrary?

Mr. O'BRIEN. There are standards laid down here, Senator, and the circumstances and the amount of the adjustment. Page 208, line 19 subsection (b) lays out the conditions that have to be complied with in order to be eligible for relief at all.

For instance, the first one is, if in one or more taxable years in the base period normal production, output or operation was interrupted or diminished because of the occurrence, either immediately prior to or during the base period, of events unusual and peculiar in the experience of such taxpayer, and so on.

Senator CONNALLY. All right.

Senator BROWN. It seems to me we are coming pretty close to what Senator George and some of the rest of us proposed a few years ago.

Mr. TARLEAU. This is certainly a much broader relief provision than in the existing law.

Senator BROWN. It does vest a very large amount of authority in the Commissioner.

Mr. O'BRIEN. Oh, yes, indeed; very broad authority.

Senator BROWN. I do not see how you can solve the problem in any other way.

Mr. O'BRIEN. Of course, his judgment is subject to review by the Board of Tax Appeals, but it is turning over a large job to him.

On page 217, line 13 is a new exclusion from excess-profits tax net income. This is an exclusion of the amount derived from bonus payment made by any agency of the United States Government on account of production in excess of a specified quota of a product the exhaustion of which gives rise to an allowance for depletion.

Page 218, line 7, gives relief against excess-profits taxes in the case of an installment basis taxpayer. If the average volume of credit extended to purchasers on the installment plan in the 4 preceding years was more than 125 percent of the volume of credit extended to purchasers during the current year, then the taxpayer may elect instead of treating those installment payments as income in the year in which he receives them, to treat them as installment payments made in the year in which he accrued them, that is, for the back year. That is a form of adjustment to take care of, as I understand it, the shrinking volume of installment sales by installment basis taxpayers.

Page 220, line 16, is a purely clerical amendment to rewrite the provision exempting investment companies from the excess-profits tax.

Page 220, line 23, strikes out the present provisions of the consolidated excess-profits tax returns, because the provisions relating to consolidated excess-profits tax returns have been combined in the ordinary corporation normal and surtaxes.

Page 221, line 8, completely rewrites supplement A of the excess-profits tax. That supplement relates to the inclusion within the average base period net income of corporations which are so-called components of the taxpayer corporation, for instance, a predecessor corporation merges into another corporation.

Under the present law, the resulting corporation can include the earnings experience of the first corporation in the base period.

This provision, however, has been substantially broadened to include all corporations which were in existence in the base period. Under the present law, only the experience of those corporations which were in existence during the entire base period is permitted to be included.

The second important change is the allowance of the so-called growth formula where the earnings in the last half of the base period exceed earnings in the first half of the base period. That formula which is now applicable to nonsupplement A companies, for the purpose of increasing the average base period net income of the nonsupplement A companies, is made applicable to supplement A corporations, so if the experience of the entire group during the last half of the base period is greater than the first half of the base period, then the taxpayer gets benefits of the growth formula.

A further change freezes the base period. Under the present law a supplement A company can have a base period varying with the date on which its taxable year in the taxable period begins. This says that the base period is the years 1936 to 1939 and freezes them that way.

It also permits corporations which are not in existence during the entire period in the base period to have a hypothetical experience based upon 8 percent of their invested capital. Under the present law that fill-up is allowed in the case of a nonsupplement A company but is not allowed in the case of component corporations under supplement A. The provision has been extended to include that case.

I think, outside of minor technical amendments, that covers all the amendments in connection with supplement A. However, I must call your attention to one provision in connection with it. The amendments made by this section are applicable to taxable years beginning after December 31, 1941—that is, this year and the following years—but if the taxpayer wants to take the benefit of these amendments for the previous excess-profits tax years 1940 and 1941, he may elect to take them, but if he takes them he takes the bad with the good, he takes the whole amended supplement.

Page 238, line 22, begins the amendment to the so-called supplement B, which relates to the highest-bracket amount. Under the present law there are some complicated provisions designed to plug the loophole where the split-up of corporations into smaller corporations results in a lower rate of excess-profits tax. For future taxable years these provisions have been eliminated because there is no inducement to split up, because the flat 90-percent corporation rate is applicable.

Various other purely technical amendments are made to this provision relating to liquidations of corporations and tax-free exchanges of property between corporations.

The next major series of changes are on page 246, line 14, relating to capital stock and declared-value excess-profits taxes. The first change is to permit an annual declaration of value. The rest of the changes in this title carry out that general policy.

They also make the necessary technical amendments on account of the change in the basis for corporation tax—that is, the allowance of the credit for adjusted excess-profits tax net income.

Senator TAFT. What is the date of the declaration?

Mr. O'BRIEN. June 30, 1942. There is a provision here for extending the time for filing those returns.

Senator TAFT. For this year?

Mr. O'BRIEN. Yes. There is a provision putting the declared-value excess-profits tax net income on an annual basis, similar to the ordinary corporation taxes. I think that is all in connection with this matter.

The next series of changes begin on page 251, line 14, Estate and Gift Taxes. In the estate tax part, the amendments, except as otherwise noted, are applicable only to estates of decedents dying after the date of the enactment of the act. The first major change is in section 402, page 251, line 21. It includes within the gross estate of the decedent property held as community property, except such part of the property as may be shown to have been received as compensation for personal services or from separate income of the other spouse.

Senator CONNALLY. How far back do you go to determine whether or not it is the income of the other spouse? Just for that taxable year?

Mr. O'BRIEN. No; derived originally from such compensation, that is, compensation for personal services or from separate property.

Senator CONNALLY. Then they have to go back to the time they were first married?

Mr. O'BRIEN. They have got to go back and find out how much of this property was received as compensation for personal services or from separate income of the other spouse.

Senator CONNALLY. If they are married 50 years they have got to figure back 50 years?

Mr. O'BRIEN. That is right.

Senator CONNALLY. You will go into a lot of trouble and get nothing.

Senator BARKLEY. How would it operate if you were married just a few weeks?

Senator CONNALLY. It is not difficult to get it now.

Very briefly, under this then, if the married man dies and he has a community estate he has got to pay on the estate as a single entity?

Mr. O'BRIEN. There is included in his gross estate the amount of the value of the community property at the time of his death.

Senator CONNALLY. If there is any record, he can go back then and exclude from that any property that his wife had from her own earnings, or as her own separate property?

Mr. O'BRIEN. As a practical matter, the executor would do that, Senator. To the extent that he could show that the wife put money into this property, that amount is excluded from the gross estate of the decedent.

Senator CONNALLY. Do you Treasury people know that under the laws of most of the community-property States every dollar of income that the wife has and every dollar of income that the husband has is community income? Do you know that? You treat these matters as if they were alien people. As a matter of fact, in my State every nickel that a husband earns by personal services, or the income from his property that he owned when he married her—he might have had a million dollars, but he gets married and half of that income belongs to his wife.

And the same with her. So, if you tax a community estate, you are taxing every dollar that comes in, I mean, insofar as income is concerned.

Those ideas just do not seem to have permeated the knowledge of the Treasury Department. They are treating this just as if it was a matter of tax evasion, or something. We have had it as a law in our State since 1840. I do not remember any income-tax laws being in existence at that time, or estate taxes either.

I will not take up any more of your time at this time, but you lay down a rule there that you can go back and sift out the incomes of the husband and wife, and you are going to have an interminable lot of difficulty. Talk about administrative difficulties, you are going to have plenty of administrative difficulties if you adopt this.

Senator TAFT. Can you explain what the law is in regard to the estate tax now?

Mr. O'BRIEN. The law is now that only a part of these community interests are included in the gross estate.

Senator TAFT. If the husband dies now in Texas, what happens? What tax is there?

Mr. O'BRIEN. Well, half of his property is included.

Senator TAFT. Half of his property is included?

Mr. O'BRIEN. Yes.

Senator TAFT. This provides that all of the property should be included except the original separate property of the wife and that which she has earned?

Mr. O'BRIEN. That is right.

Senator CONNALLY. Senator Taft, under the law of my State, when he dies any property that she had, separate property, goes to her, because it is hers all the time. The income from it, however, due to the marriage relationship, goes one-half to the husband and one-half to her. Upon death, the joint earnings that have been accumulated since they married, whether from income or from separate property or personal services or in any other way except by gift, forms a community fund.

Now, upon the death of the husband or wife, one-half of that is the property of the survivor, so she does not pay any tax on it. His half goes to the estate and is subject to, and does pay, a tax.

When she dies, then in turn her one-half pays the tax. It is based absolutely on the theory that it never was his at all, it has been hers all the time.

Senator TAFT. I am expressing no opinion in favor of it or against it, I just want to get the distinction.

Senator CONNALLY. I understand. You asked what would happen when they died.

The CHAIRMAN. Proceed, Mr. O'Brien.

Mr. O'BRIEN. The next section on page 252, line 21, relates to powers of appointment. I think that can be summarized by saying that there has been a general tightening up of the provisions relating to powers of appointment in order to close the substantial loopholes that exist in the present law.

Page 256, line 23, relates to the proceeds of life insurance.

In the main, this section writes into the statute the rule announced by the regulations of the Treasury to the effect that if life insurance is purchased with premiums paid, directly or indirectly, by the decedent to the extent of his proportionate payment of the premiums, the amount of the life insurance is included in his gross estate.

Senator DANAHER. What is the theory of it, please?

Mr. PAUL. The theory of using the source of premium payments as a test of estate taxability?

Senator DANAHER. Yes.

Mr. PAUL. Up to January 10, 1941, the test had been whether the decedent insured had any interest in the policy at the date of death. That test did not work, it permitted avoidance of tax.

That is, it permitted an avoidance in that the insured would transfer the incidents of ownership to his wife, so that, outside of the

contemplation of death provision, there would not be any tax on his estate, although a great deal of insurance would be existing.

Thus section 811 (g) would be completely avoided.

About a year ago the Treasury put into effect a source of premium test. The *Bailey case* in the Court of Claims and various other courts originated the theory that the true test of taxability of insurance proceeds should be who paid the premiums.

Thereupon, the regulations were adopted, incorporating these decisions, and this statutory provision really enacts the rule. There is a double test now, either in proportion to payment of premiums there is taxability in the estate, and also if the decedent retains any incidents of ownership there is a taxability.

Senator GERRY. Mr. O'Brien, was the word "illegitimate" on line 4, page 254, in the statute before?

Mr. O'BRIEN. No; that is new.

Senator GERRY. What was the reason for that? An enlargement?

Mr. O'BRIEN. Yes; an enlargement. The thought was we were not altogether sure what the term "descendant" meant, so we decided to make it perfectly clear.

Senator BROWN. How does that rule, Mr. O'Brien, in regard to insurance exemptions operate in the community-property States?

Would it be taxable one-half or in its entirety?

Mr. O'BRIEN. Look at page 258, Senator. There is a whole rule on it. That is page 258, line 8.

Mr. PAUL. Page 258, line 8, section (4).

Senator BROWN. Oh, yes; I see it covered here.

Senator DANAHER. Did you mention, Mr. Paul, that it is only one-half?

Mr. PAUL. No; we carry over the rule that has just been discussed, that is used for estate-tax purposes, to the insurance provision there. If the husband's earnings are used to pay premiums that is a source of the premium payment.

Senator DANAHER. The more I hear of a community-property State, the better I like it.

I think we had better transfer to the Texas basis.

Senator CONNALLY. Well, that is pretty near right.

Senator BARKLEY. What connection does this life insurance company provision have with the $40,000 provision?

Mr. O'BRIEN. None, sir. That comes later on in the bill.

Senator BARKLEY. They raised it to $60,000 in the House bill?

Mr. O'BRIEN. That is right. They combined the two exemptions of $40,000 and $40,000 and made it $60,000.

Mr. PAUL. It cost us about $15,000,000 in revenue.

The CHAIRMAN. Every estate does not have insurance, so we actually get a raise of $20,000.

All right, Mr. O'Brien.

Senator BROWN. Is there any constitutional doubt about your right to enact subsection (4), on page 258, to determine whether the net income came from a source other than described?

Mr. PAUL. I do not think there is any doubt about that.

Senator BROWN. There has not been any decision on that subject?

Mr. PAUL. No; but there are a great many decisions in various cases, such as the *Jacobs case*, that deal with the joint-estate provision.

Senator TAFT. I do not quite understand, Mr. Paul, this provision in connection with the $40,000 exemption. Does that mean that insurance policies for which the decedent has paid the premiums are taxable regardless of the $40,000?

Mr. PAUL. The $40,000 used to be an exclusion irrespective of this other rule. The other rule applied only with respect to insurance over $40,000. Forty thousand dollars under the old rule, previous to this act, was exempt in any event, if it was payable to beneficiaries other than the insured.

Senator TAFT. Yes.

Mr. PAUL. That is a totally different matter from the question of taxing the insurance proceeds over $40,000.

Senator TAFT. Yes.

Well, now, if this was purchased with premiums paid by the decedent, it is taxable regardless of the exemption?

Mr. PAUL. Of course, the new rule was put in the statute which does not give the special life-insurance exclusion. That is why it is hard to reply to that, but if we had continued the old $40,000 exemption, the new rule would only apply with respect to insurance over the $40,000.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 259, line 6, relates to deductions which are not allowable in excess of the value of certain property of the estate. The provision disallows deductions to the extent that they exceed the value at the time of the decedent's death of property which is subject to claims. In any number of instances some property does not go to the executors, not included in the gross estate, but it has claims against it. If those claims are allowable against what is included in the gross estate, that means a reduction in the value of the estate for estate tax purposes. This says if those claims are against property not included in the gross estate, then the claims are not allowable for the purpose of deduction of the estate tax.

Senator GERRY. How does that work out? I do not think I understand it.

Mr. O'BRIEN. Take a case in which you have land that is subject to a mortgage, land that is worth $2,000 and that has a mortgage of $1,000 on it.

The land does not go to the executor. Now the claim of $1,000 may have to be paid by the executor, notwithstanding the fact that all that property is not in his hands. Therefore, you disallow——

Mr. PAUL. Just a minute. I think you are wrong.

Mr. O'BRIEN. All right, I am wrong.

Mr. PAUL. I think the best example of explaining that provision comes in connection with insurance. A great many State laws exempt insurance from the debts of the decedent. I remember one case where there was $2,000,000 of insurance in an estate but there were $6,000,000 of debts, but the debts were not enforcible against the insurance.

Senator CLARK. You mean the insurance was not made payable to the estate?

Mr. PAUL. No; this was not made payable to the estate. I presume, in most States they are made payable to the estate and in that case it would be different. Here was a family getting $2,000,000 of insurance with $6,000,000 of claims that could not be collected deductible against the insurance.

Senator CONNALLY. The theory there is that the beneficiary of an insurance policy takes that as his property and not the property of the estate.

Mr. PAUL. That is true. That is the theory of the estate law. That is true, Senator; but our theory is insurance is taxable over a certain amount. It is not fair to allow claims that are not enforcible against the assets of an estate to be deducted in computing the net estate. In other words, you can wipe out the net estate with claims that cannot be collected against certain assets in the estate.

Senator CONNALLY. On the other hand, if you do that, you make it impossible for me or anyone else, that wants to assure the income of property to your wife and your child, you make it subject to the hazards of my business which I am trying to protect?

Mr. PAUL. That is true now and was true before. All insurance over a certain amount is subject to the tax. In other words, the theory of these State laws does not come through to the Federal laws.

Senator BARKLEY. In other words, if I should die and leave $2,000,000—which I will not—and I owed a million dollars, that they could not collect out of my estate, what you are seeking to do is to avoid the beneficiary of my insurance being able to deduct an uncollectible debt against the estate from the amount of insurance she would receive?

Mr. PAUL. That is right.

Senator TAFT. Which is taxable.

Senator BARKLEY. Which is taxable.

Mr. PAUL. The same theory goes through to mortgages.

Senator GERRY. How would it work out in the mortgages?

Mr. TARLEAU. Suppose you have a mortgage on property worth $10,000 and the mortgage is $30,000 but the only property out of which the debtor can get his $30,000 is the mortgaged property; now, the property goes in at $10,000 in the estate tax return, and you have a $30,000 claim, the claim can only be satisfied against that property. To allow the excess of $20,000 to be deducted against other property would reduce the value of that property for estate tax purposes without any warrant, since that other property is not subject to the payment of that $20,000.

Senator TAFT. In that case you allow the deduction of $10,000 instead of $30,000?

Mr. TARLEAU. That is right.

Mr. O'BRIEN. Page 263, line 9, is the next change. It provides for the case where a claim against the estate is founded on a promise or agreement of the decedent to make a gift to a charity, then if that gift is made the estate gets a deduction for it just as if the bequest were made to the charity in the first place.

Senator TAFT. I wish it were done years ago.

Mr. O'BRIEN. It is not retroactive, Senator.

The CHAIRMAN. You say it is not retroactive?

Mr. O'BRIEN. It is not retroactive.

Senator BYRD. You mean by that if you sign a pledge to make a certain gift to a charitable organization, then the amount of the pledge can be deducted from the estate?

Mr. O'BRIEN. If the claim is enforcible against the estate and the amount given to the charity it is considered just as if you made the bequest to the charity in the first place by your will.

Page 264, line 12, makes numerous technical amendments to provisions relating to deduction on account of previously taxed property. The major change is to correct an error in the 1932 act under which, literally, the deduction is not allowed if the only tax paid is the additional estate tax of 1932. In addition to which there are a number of minor loopholes closed up in connection with that problem. These amendments are made retroactive because of that mistake, and the retroactivity of the amendment in the case of the allowance of the deduction is to the benefit of the taxpayer.

Page 269, line 15, permits a deduction for estate-tax purposes in case a disclaimed legacy passes to charity. The situation is one in which, let us say, the residuary legatee of the estate is the charity. The decedent's son disclaims his legacy, and the result is that the amount of that legacy goes to charity. This says the amount of that legacy going to charity shall be considered just as if it were a bequest directly to charity.

Senator CONNALLY. Does that apply to lapsed legacies? Suppose the son died, and there is no change in the will, that legacy would lapse?

Mr. O'BRIEN. Lapse?

Senator CONNALLY. Yes. It would be the same in legal effect as if he disclaimed?

Mr. O'BRIEN. Yes.

Senator CONNALLY. I do not know whether the word "disclaimed" would cover it or not.

Mr. O'BRIEN. Well, lapsed legacies now are covered.

The CHAIRMAN. That is already in the law.

Mr. PAUL. Confusion had arisen where there was not a disclaimer, and we are trying to correct that.

The CHAIRMAN. This disclaimer must be made prior to the date of the filing of the tax return; is that right?

Mr. O'BRIEN. Yes. This amendment is made retroactive and applicable to estates of decedents dying after December 10, 1939. That is the date of the enactment of the Internal Revenue Code.

Page 270, line 17. The estate-tax-deduction section is sprinkled all through with provisions relating to the charitable organizations to which a bequest or devise constitutes a deduction from the gross estate, and there is language which denies the deduction unless no substantial part of the activities of that organization shall be carrying on propaganda or otherwise attempting to influence legislation. We found one situation in which that language was not put in and inserted it to round out the whole.

Senator CONNALLY. Does that apply to columnists?

Mr. O'BRIEN. No. Page 271, line 8, reverses the credit for State inheritance taxes and gift taxes. Under the present law the gift tax is taken off first and the State tax is taken off second. This says that the State tax shall be taken off first and the gift tax second, the effect of which is to increase the amount of the credit on account of local State taxes.

Senator CONNALLY. The State has inheritance taxes where each heir pays a certain rate. In giving the credits I think you segregated those inheritances.

Mr. O'BRIEN. Yes.

Senator CONNALLY. They allowed deductions for five children or two children.

Mr. O'BRIEN. Whatever that tax is.

Mr. PAUL. You get a credit of 80 percent of the total local State or inheritance tax. There is no distinction made for the purpose of the credit. The trouble with the present statute here is you take the gift tax off first, and that reduces the amount against which the 80-percent rule works. We have reversed it, applying the 80-percent credit to the total tax, and then applying the gift-tax credit afterward.

Senator BROWN. I do not know whether I understood Senator Connally's question right. It seems to me your answer was not in accordance with my understanding of the Federal estate tax. The Federal estate tax is against the whole estate, not a tax on the inheritance.

Mr. PAUL. It is an estate tax, it is not an inheritance tax; that is right.

Senator BROWN. Most State taxes are based upon the inheritance received by the respective heirs. In other words, a State tax is much less on leaving five children when one dies than leaving one child. As far as the Federal Government is concerned, it is practically the same.

Mr. PAUL. I was speaking about the credit against the Federal tax.

Senator BROWN. I would like to get that straight. I myself have always felt the Federal Government ought to follow the State plan rather than the plan it followed. Your reply to Senator Connally's question, I think was contrary to what I understand.

Mr. PAUL. I was not trying to describe the nature of the Federal tax. You are not quite correct about that. The Federal tax is a tax on the estate. Whether or not it should be, that is another quesion.

Senator GELRY. The Senator said they were only on the beneficial interests. For example, in my State we have both a tax on the estate and on the inheritance beneficial interests.

Mr. PAUL. There may be two taxes, of course.

Senator BROWN. I do not know that that is the case in every State, but I think most States tax on the inheritance basis.

Mr. PAUL. I do not know what the general practice is now. I know there are some States which have turned from the inheritance to the estate tax.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 272, line 4, expands and clarifies the provision of the present law under which a transferee of a part of the estate of the decedent is liable for the estate tax if the estate tax is not paid.

Page 273, line 7, allows a specific exemption of $2,000 to estates of nonresidents, not citizens of the United States. Corresponding provisions relate to the filing of returns in such cases.

Page 274, line 11, section 413, relates to the estate-tax specific exemption. The effect of this is to strike out the existing specific exemption of $40,000, to strike out the insurance exclusion of $40,000, and to make the exemption $60,000 in all.

Senator CONNALLY. How much under this would be exempt from the estate tax?

Mr. O'BRIEN. Sixty thousand dollars, whether it is in insurance or whatever it is.

Senator CONNALLY. Whether it is in property or whether it is insurance?

Mr. O'BRIEN. No matter what it is.

Senator CONNALLY. It has been $40,000?

Mr. O'BRIEN. It has been $40,000 in insurance and $40,000 otherwise.

Senator BROWN. This reduces it from $80,000 to $60,000?

Mr. PAUL. This reduces it from $80,000 to $60,000 only if the decedent is insured to the extent of $40,000.

Senator CONNALLY. The effect of that is if a man leaves more than $60,000 worth of property he is denied the insurance benefit.

Mr. O'BRIEN. That is true. He gets just one $60,000. The insurance may be in the $60,000.

Senator CONNALLY. How is that?

Mr. O'BRIEN. He may have $40,000 insurance and $20,000 other property, making a total of $60,000.

Senator BROWN. What is the general effect of the exemption on revenue?

Mr. PAUL. The exemption costs about $15,000,000.

Senator BROWN. You lose rather than gain.

Mr. PAUL. We lose $15,000,000 in the estate-tax amendment and pick up $7,000,000 in the gift-tax amendment.

Senator TAFT. What about the effect of that other provision? Does that bring in any money, the one we were discussing awhile ago, put in by regulation in January?

Mr. PAUL. That is existing law. That is the way the law is now being administered. It will pick up revenue.

Senator TAFT. The law last year was administered differently. Do you know how much that change will increase it?

Mr. PAUL. No; I do not remember.

Senator BYRD. Does the Treasury recommend this amendment?

Mr. PAUL. The $60,000?

Senator BYRD. Yes.

Mr. PAUL. Both staffs agreed on that amendment.

Senator VANDENBERG. Did the House committee vote on exempting life-insurance premiums?

Mr. PAUL. No.

Senator BROWN. I want to ask one more question. Is any change being made in the rate of interest that is charged to decedent's estates that are unable to pay within the time limit?

Mr. O'BRIEN. No.

Senator BROWN. What is the rate now?

Mr. O'BRIEN. Four percent.

Senator BROWN. We modified that considerably a couple of years ago. No change has been made in that?

Mr. PAUL. No change has been made.

Senator BROWN. You can still extend it over a period of something like 8 or 9 years?

Mr. PAUL. Ten years.

Senator DANAHER. Mr. Chairman, a question.

The CHAIRMAN. Yes; Senator Danaher.

Senator DANAHER. What would be the effect if you had a single $80,000 general exemption?

Mr. PAUL. The effect, in the first place, would be it would cost us a lot of money in revenue. It would increase everybody's exemption, instead of permitting an $80,000 exemption simply to people who can take out $40,000 in insurance.

Senator DANAHER. Why should you make the equivalent of a capital levy on a man who saves and buys insurance?

Mr. PAUL. What is the estate tax but a capital levy?

Senator DANAHER. If you had a general exemption of $80,000, you would hit everybody, whether the man has insurance or not.

Mr. PAUL. Our theory is the levy should be general, but that $60,000 is enough in these times.

Senator TAFT. What is the advantage in that?

Mr. PAUL. We are losing $15,000,000.

Senator TAFT. I mean what is the corresponding benefit to us losing $15,000,000 and annoy everybody practically?

Mr. PAUL. We could easily remove that effect by reducing the $60,000.

Senator TAFT. Surely.

Mr. PAUL. The presence of the $40,000 special life-insurance exclusion seems to us to put into the statute a discrimination in favor of a certain type of investment, in favor of a certain type of person who can get insurance. Not all people can. The provision has permitted a great deal of avoidance of tax. It is quite fashionable now to get $40,000 insurance when your estate is in the millions.

Senator DANAHER. How much of the deficit-financing program is going to be handled by life-insurance companies?

Mr. PAUL. Oh, the insurance companies are buying bonds very heavily, but I do not see what the relation of what the insurance company does is to what is allowed as an exemption to a deceased insured man.

Senator TAFT. It seems to me this is the time to encourage investment in insurance. It seems an inappropriate time to make the change, particularly if we care going to lose $15,000,000 by it.

Mr. PAUL. If the insurance companies are investing heavily, that is right; but it is a matter of policy and it seems to us a bad provision in the statute not compensated for or without relation to the activities of the insurance companies for which we are very grateful.

Senator DANAHER. It would seem to me that while buying War bonds out of current income might be the very best way of curbing inflation, the second best way would be to buy from current income life insurance policies, because you are diverting from current funds money that might be spent in competition for the dwindling supply of consumer goods and at the same time you are making possible heavy investment in the Government bonds. If you continue the $40,000 exemption for life insurance, which certainly has been in the law for time immemorial, as far as I can recall, it seems to me you would be denuding the contract of one of the most difficult features.

Mr. PAUL. The insurance contract?

Senator DANAHER. Yes.

Mr. PAUL. We are very decidedly against the avoidance of tax by the insurance mechanism.

Senator CONNALLY. Under your new law if the man wants to take out $40,000 in an insurance policy he may do so?

Mr. PAUL. He may take out $60,000.

Senator CONNALLY. The only thing is he is denied then the additional $20,000 under the present law in other property. That is the effect of it?

Mr. PAUL. That is right.

Senator CONNALLY. If a man wants to take out insurance rather than buy a house or store, he can do it now?

Mr. PAUL. That is right.

Senator VANDENBERG. If we finally get around to it and we are pressed by the necessity of getting some increased revenue, would that be a logical way to increase your revenue, according to your philosophy of this situation, rather than to go back to the 40–40?

Mr. PAUL. You mean if we are pressed for the need of increased sources of borrowing?

Senator VANDENBERG. I mean when this bill is all totaled up and we need some more money, would you be too unhappy if we found $15,000,000 more by going back to the 40–40?

Mr. PAUL. Yes; I would prefer to lose the $15,000,000 to putting back that provision, which seems to me to do much more harm than losing the $15,000,000 in revenue.

Senator BARKLEY. It is not totally lost, anyway.

Mr. PAUL. Yes, it is. It is only fair to say it is, because the gift tax amendments do not really offset that.

Senator BARKLEY. I think you said it was $7,000,000.

Mr. PAUL. I said the total effect of this was a loss of $15,000,000 and then I said the gift tax amendments, which I must say are independent of this one, bring in $7,000,000.

Senator BARKLEY. You would offset the $15,000,000 loss in one category with a $7,000,000 gain in another?

Mr. PAUL. I was just doing that as a matter of convenience.

Senator BARKLEY. I wish you could do that in regard to all taxes. Even if you do not have this provision you would probably be changing the other.

Mr. PAUL. I have just been talking about them as being consolidated. They are frequently referred to together, the estate and gift taxes, and I volunteered the information that the net loss would be $7,000,000. If we wanted to make up the $15,000,000, we could reduce the $60,000 to $50,000, or something of that sort.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 274, line 19, is a purely technical amendment to the provision relating to the statute of limitations in the case of estate taxes, and a somewhat similar amendment is made to this provision as was made in the income-tax amendment to section 322.

Page 275, line 1, begins the gift taxes. The gift-tax amendments are applicable only to gifts made in the calendar year 1943 and succeeding calendar years.

The first amendment, section 452, page 275, line 7, writes into the gift tax a rule similar to the estate-tax rule relating to powers of appointment.

Page 277, line 1, provides that where there is a gift of community property the gift shall be considered the gift of the husband except that such amounts as are shown to have been received as compensation for personal services actually rendered by the wife, or that are derived originally from such compensation or from separate property of the wife, and in that case to the extent of such amounts the gift is considered the gift of the wife.

Page 277, line 11, reduces the exclusion from net gifts. Under the present law there is excluded from net gifts an amount equal to $4,000 for each year to any number of donees. That is reduced to $3,000 for 1943 and succeeding years.

Senator GERRY. Mr. O'Brien, what is that section (d) on page 275? What is the power of appointment?

Mr. O'BRIEN. I did not hear that.

Senator GERRY. How does that affect the question of the power of appointment? What does that do?

Mr. O'BRIEN. What it does is tax certain exercises and nonexercises of powers of appointment as a gift. I think the kind of thing you are interested in is where a bank or a trust company is authorized to appoint among a limited class of beneficiaries, the exercise of that power of appointment does not constitute a gift. The so-called fiduciary powers are not taxable under either the estate tax or gift tax.

Page 278, line 4, section 455, reduces the specific exemption of gifts. Under the present law you can give away, during your lifetime, $40,000 above the exclusions and not be subject to any gift taxes. This proposes that the so-called lifetime exemption for gifts be reduced from $40,000 to $30,000. All above $30,000 is taxable.

Page 279, line 3, makes the same kind of amendment to the statute of limitations on gift taxes as was made in the estate tax.

Page 279, line 9, makes purely a technical amendment to the gift tax under which stock in a domestic corporation owned or held by a nonresident citizen of the United States is deemed to be property situated in the United States for the purpose of the gift tax.

Page 279, line 19, begins the amendment to prior revenue acts and miscellaneous provisions. Section 501 allows as a credit for undistributed profits taxes levied under the 1936 Revenue Act the amounts which cannot be distributed in that the earnings and profits would not be adequate. It is a somewhat similar relief provision to the one I spoke of in connection with the personal-holding-company tax.

Page 281, line 21, imposes a stamp tax on certain insurance policies written by foreign insurance companies. In the main the tax is imposed at the rate of 4 cents on each dollar, or fractional part thereof, of the premium charged for indemnity, fidelity, and surety bonds, and for insurance other than life, and at the rate of 1 cent on each dollar, or fractional part thereof, of the premium charged for reinsurance on accident policies, annuity contracts, or contracts of insurance, and so forth. The attempt here is to equalize the situation between domestic corporations engaged in casualty and other kinds of insurance and foreign corporations where the insurance is taken out in the United States but the policy is countersigned abroad.

Senator VANDENBERG. Does that apply to Lloyds for instance?

Mr. O'BRIEN. Lloyds; yes.

Senator TAFT. That applies only to foreign insurance?

Mr. O'BRIEN. Yes.

Senator CLARK. Have you got any idea how much that raises on the present basis? I never got any estimate on the effect it would have on the revenue. It does not make any difference, it could be done anyhow.

Mr. PAUL. Yes; it could be done anyhow. I do not think that is a tremendous sum, but it should be done.

Senator CLARK. These foreign insurance companies are not subject to any regulations.

Mr. PAUL. That is right.

Mr. O'BRIEN. Page 284, line 21, provides that a suit against the collector of internal revenue shall be considered a suit against the United States in the application of the doctrine of res judicata; that is, in determining whether or not the issue is settled. It provides in such case, in a subsequent suit, the doctrine shall be applied as if the United States had been a party to the suit in all suits instituted after June 15, 1942, and in all proceedings before the Board of Tax Appeals, and on review of the decision of the Board of Tax Appeals, where the petition to the Board of Tax Appeals was filed after June 15, 1942.

Senator DANAHER. Have you had some cases?

Mr. O'BRIEN. We have had some.

Mr. PAUL. There is a case in the Supreme Court, the *Nunnally case*, just decided this last term, that held the other way. We are overruling the Supreme Court here in a way.

Senator DANAHER. Maybe we will not be.

Mr. PAUL. So far we are.

Senator BARKLEY. The Supreme Court interprets the law. They do not set down the principle.

Mr. PAUL. That is quite correct.

Mr. STAM. I might say the Supreme Court said in their opinion that the Congress ought to correct the situation.

Senator BARKLEY. So we are not overruling them; we are complying with them.

Mr. PAUL. We are complying with their suggestions.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 285, line 13, changes the name of the Board of Tax Appeals to the United States Tax Court and the names of the members of the Board to the presiding judge and the judges of the United States Tax Court.

The CHAIRMAN. Is that all it does?

Mr. O'BRIEN. That is all.

The CHAIRMAN. Is there anything that follows from that that does not follow from the present law?

Mr. O'BRIEN. I do not think so.

Senator TAFT. It does not give them life tenure?

Mr. O'BRIEN. It certainly does not give them life tenure.

The CHAIRMAN. Have they life tenure now?

Mr. O'BRIEN. No.

The CHAIRMAN. Does this give it?

Mr. O'BRIEN. It does not. The specific provision on page 285, line 21, says:

The jurisdiction, powers, and duties of the United States Tax Court, its divisions, and its officers and employees, and their appointment, including the designation of its officers, and the immunities, tenure of office, powers, duties, rights, and privileges of the presiding judge and judges of the United States Tax Court shall be the same as by existing law provided in the case of the Board of Tax Appeals.

Senator CONNALLY. The argument that was made to me about this thing was the reason they wanted to name it a court was in cities around the country the Federal judges frequently would not permit them to use the courthouses and quarters, they said it was not a court but just a commission, and if they let them have the courthouse they would have to let every other commission have it that comes down, or any other Federal agency.

Senator BARKLEY. Under this you would call them judges?

Mr. O'BRIEN. Yes; you would call them judges.

Senator CONNALLY. They like to be called judge instead of commissioner; is that about the upshot of it?

Mr. O'BRIEN. This statute says you have to call them judge. It says: "The Board shall be known as the United States Tax Court, and the members thereof shall be known as the presiding judge and the judges of the United States Tax Court." I do not know that you would go to jail if you failed to call them judge, but the statute says they shall be known as judge.

Senator CONNALLY. You say "rights and duties." It is not granting them any more privileges except those specifically set forth. I do not think we ought to take any chance on retirement privileges or exemption from taxation.

The CHAIRMAN. I do not know whether the question has been looked into, but if they are given the status of a court and become judicial officers, I think we ought to make an inquiry as to whether or not that would entitle them to retirement benefits.

Mr. O'BRIEN. Senator, they are not given the status of a court by this bill. This merely changes their name from the Board of Tax Appeals to United States Tax Court. To acquire the status of a court, what you would have to do would be to create a court, fire the existing members and appoint new members to a court, and this proposes no such thing. It says these people who are there, this organization shall be known as the United States Tax Court and the members shall be known as the presiding judge and judges of the United States Tax Court. Their status is unchanged, and I think subsection (b) of this section clinches the matter.

The CHAIRMAN. It would seem to; yes.

Senator CONNALLY. Under the present law all judges pay the income tax if appointed subsequent to the tax law?

Mr. O'BRIEN. Yes.

Senator CONNALLY. This would not exempt them in any way from that?

Mr. O'BRIEN. No.

Senator CONNALLY. All judges pay the tax?

Mr. O'BRIEN. That is right.

Senator CONNALLY. I mean after a certain date.

Mr. O'BRIEN. Yes.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 286, line 19, relates to the requirement of filing notice of a tax lien. Under the present law as construed by the Treasury all the Treasury need do to establish a tax lien is to file notice of a lien in the proper place designated by the State for filing notice of lien. There have been some recent decisions indicating that this statute has been interpreted to mean that the Treasury must comply with the requirements of State law in order to have a valid notice of lien, particularly the requirement that the property to which the lien will attach be particularly described. This goes back to the construction which the Treasury has heretofore put on the statute, which is merely that they have to file a notice of lien.

Senator CONNALLY. You mean that gets all his property regardless of whether they describe it or not?

Mr. O'BRIEN. That is right, all his property within the State.

Senator CONNALLY. It looks to me like not in his interest but the public interest, people dealing with the property, there ought to be some description that the proposed purchaser would know whether he is getting a piece of encumbered property or otherwise. Not for his advantage but to help innocent purchasers who might deal with it.

The CHAIRMAN. When the lien is filed it is notice that all of his property is subject to the assessment.

Senator CONNALLY. He does not have to file it in the county either. Now, you can file it in the Federal district court. Is that right?

Mr. TARLEAU. You have to file wherever the State requires you to file.

Mr. PAUL. The district court requirement only applies where there is no local requirement.

Senator BROWN. Does this mean the filing of a lien in one county would cover property in another county, where the State law requires it to be filed in the county where the property is situated?

Mr. PAUL. No.

Senator TAFT. The State must pass a specific law saying that the Federal Government can file the lien.

Senator CONNALLY. Most States have a general act covering the filing of any sort of a lien.

Senator TAFT. I think under the Ohio law you can file in the district court, because there is no Ohio law authorizing the filing of a lien, except a general judgment law. Of course, every judgment is a lien. They have to go through the district court anyway. It does not make any difference because they have to go through the district court anyway to file liens on real estate before Federal judges.

The CHAIRMAN. This seems specifically to require the filing under the State law, where the State has an act governing the filing. Otherwise, it can be filed in the office of the clerk of the United States district court for the judicial district where the subject of the lien is situated.

Senator BROWN. I think there is something to Senator Taft's point. By the use of the language, "filing of such notice," what you mean is a notice similar to the notices of liens required by the State law. It seems to me we ought to revamp that language slightly to conform with your desire.

Mr. PAUL. If we need to, we will. Certainly it is clear what our intention is.

Senator BROWN. Yes; it may mean they would have to pass a specific law with respect to Federal notice.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 287, line 18, suspends the period for the computation of interest in the case of nonresident alien individuals and foreign corporations, from the period beginning with the date of the enactment of this act to the period ending with the fifteenth day of the sixth month following the month of termination of the war, if the payment of their tax was prevented due to restrictions imposed on such individuals or corporations by any foreign country. The idea is this: The people cannot pay the tax, the foreign country prevents them from doing it, and therefore the running of interest is suspended for the period outlined.

The CHAIRMAN. Is there any provision made in the case of the man in foreign service, or military service, regarding the time of filing?

Mr. O'BRIEN. Yes, Mr. Chairman. On the next page, page 289, is an elaborate provision on that.

Senator TAFT. What about the case where there is a nonalien and the money cannot be paid because the United States Government has issued an order preventing it?

Mr. O'BRIEN. That is not included here. It is only where it is prevented by reason of the action of a foreign government.

Senator TAFT. I was wondering what you would do where the United States Government says it cannot be paid.

Mr. PAUL. They will all have to pay the taxes.

Mr. O'BRIEN. Page 288, line 10, exempts from the stamp tax conveyances and transfers of securities in pursuance of orders of the Securities and Exchange Commission under supplement R. The situation is that a public utility holding company is obliged to transfer stock to some other company or property in obedience to an order of the Securities and Exchange Commission. This says they will be exempt from the stamp tax on the transfer of that stock or property.

Page 289, line 10, begins a long series of amendments relating to the postponing of time during which certain acts are to be performed by reason of the war. What it does is done in the case of people who are outside the Americas. It says the time when they are outside, if they are outside for more than 90 days continuously, shall not be considered in determining the period in which they have got to file an income-tax return, file a petition to the Board of Tax Appeals, bring suit, or have a suit brought against them. There are elaborate provisions suspending the time in which those acts may be performed on both the side of the Commissioner and the taxpayer.

The CHAIRMAN. It is only in case they are in Central America or South America?

Mr. O'BRIEN. There is a further provision in the case of a soldier. The Commissioner may, by regulations, apply the provisions of this section to persons who, by reason of being in the military and naval service, are outside of the States of the Union, or the District of Columbia. So these provisions can be applied to the soldier who is in Venezuela or Trinidad or Bermuda.

Senator VANDENBERG. Are they outside the Americas when they are in the Philippine Islands?

Mr. O'BRIEN. Yes; they are outside the Americas when they are in the Philippine Islands. The Americas are roughly the North and South American continents, and the islands in the Caribbean.

Senator VANDENBERG. Does it not apply to the Philippine Islands?

Mr. O'BRIEN. It does apply to the Philippine Islands. Even when they are inside the Americas, outside of the States of the Union and the District of Columbia, the Commissioner may apply these provisions to such soldiers.

Senator DANAHER. It would bring in the civilian employees of contractors engaged in base construction?

Mr. O'BRIEN. If they are outside the Americas; yes, sir.

The CHAIRMAN. Does that mean that it is extended to a soldier or sailor in the armed forces, that the Commissioner may do so by general order?

Mr. O'BRIEN. By regulation; yes.

The CHAIRMAN. Would he also have the authority and power to deal with it in specific cases if the question arose, or must it be by general order?

Mr. PAUL. That could be dealt with separately in each regulation. That is the idea of doing it by regulation, to give flexibility to it.

The CHAIRMAN. I see. All right.

Mr. O'BRIEN. I take it he can lay down general standards in his regulations and then apply the general standards to specific cases.

Mr. PAUL. Yes.

Mr. O'BRIEN. Page 297, line 1, begins title VI, the excise taxes.

Senator VANDENBERG. Those are the sales taxes.

Mr. O'BRIEN. Excise taxes; they are not all sales taxes, Senator. The changes in these excise taxes are made effective on the first day of the first month which begins more than 10 days after the date of enactment of the act.

The first change is to increase the tax on distilled spirits from $4 to $6 per proof gallon. Similarly, a floor-stocks tax at the rate of $2 per proof gallon is imposed on distilled spirits held for sale on the date when these provisions become effective, that is, the first day of the first month which begins more than 10 days after the date of enactment of the act.

Senator BARKLEY. In view of the conversion of practically all the distilleries for the industrial alcohol plants for war purposes, what effect will this have on the revenues?

Mr. O'BRIEN. Of course the whisky tax is a tax on withdrawal.

Senator BARKLEY. I know, but if they are not making whisky but are going to make industrial alcohol for war purposes, which they are planning to do, over a period of years the amount that will be withdrawn from bonded warehouses for tax purposes would be reduced, I guess.

Mr. PAUL. We have tried to take that into consideration, Senator Barkley. Of course there is quite a supply, I understand about a 4 years' supply. We have tried to allow for that in our calculations of revenue.

Senator BARKLEY. I wondered if in the production of this commodity it would tend to offset the increase in the tax that you put on it?

Mr. PAUL. There would be a tendency in that direction. We tried to allow for it in our estimate.

Senator CONNALLY. If you have got a 4 years' supply of whisky on hand, the transfer over to industrial alcohol would not affect the supply very badly.

Senator BARKLEY. Not for the time being, but if the situation should last for 4 years the situation would be a hiatus.

Mr. PAUL. You are quite right.

Senator GUFFEY. If you wanted to buy by the case it would cost $6 more under the new law.

Senator BARKLEY. I was not interested in that phase of it.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 299, line 1, raises the rates on fermented malt liquors; that is, beer, and so forth, from $6 to $7 per barrel.

The CHAIRMAN. The floor stock provisions in both cases follow pretty generally the general law?

Mr. O'BRIEN. We follow the latest pattern of the floor stock provisions in the law in each case. The floor-stock rate of $1 per barrel of 31 gallons is to be paid for beer held for sale.

Page 300, line 18, section 604, raises the rates on wines from 8 cents to 10 cents per gallon and from 30 cents to 40 cents per gallon, and from 65 cents to a dollar. A similar change is made in the rates on sparkling wines, liqueurs, and cordials.

Senator CONNALLY. Does that amendment provide the same relationship between the different kinds of wines that we had formerly? We always had a query here on how much each wine should have.

Mr. PAUL. I am not sure it does. There was a good deal of discussion on that point. The original Treasury proposals were not followed. The original Treasury proposals were more greatly reduced on still wine.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. A floor stocks tax equal to the increase in rates of the tax on wines is imposed on wines which are held for sale on the effective date of the title.

Page 302, line 9, section 605, relates to the tax on tobacco, cigars, cigarettes, and cigarette papers and tubes. The rate on smoking tobacco has been raised from 18 cents per pound to 24 cents per pound.

Senator BARKLEY. Let me ask you about that. The tax on tobacco, unmanufactured, where the farmer either himself or through an agent employed by him sells tobacco for consumption direct to the consumer, whether it is chewing or smoking tobacco, it is put up in packages for mailing purposes, the mail-order business, the same type of tobacco can be used for chewing and for smoking. I mean, many people chew tobacco that has not been put up in packages and sweetened and treated and medicated, and to make them smell good. There is no difference in the cost of producing that tobacco and putting it up in these packages and wrapping it up for mailing purposes as between the type that is chewed and the type that is smoked; therefore, why make the difference in this rate? Why make the difference in the rate in the type of tobacco where the grower is permitted under the law to sell it to the consumer directly, either himself or by the employment of an agent?

Mr. O'BRIEN. I have had the same trouble myself, Senator. I asked the Treasury people and they said they could distinguish between smoking and chewing tobacco.

Senator BARKLEY. They could?

Mr. O'BRIEN. Yes.

Senator BARKLEY. I do not see how it is possible in that particular type where it is all put up alike; I do not see how it is possible to distinguish it. A man can crumble it up and put it in his pipe and smoke it, or he can wad it up and put it in his mouth and chew it.

Senator CLARK. Some chew and smoke the same tobacco at the same time.

Senator CONNALLY. Don't they sometimes chew it and then dry it up and smoke it?

Senator BARKLEY. You are probably thinking about the cow that chews her cud twice.

The CHAIRMAN. Did not the State Department raise some question about the tobacco tax?

Mr. PAUL. I did not hear the question.

The CHAIRMAN. I say, has not some question been raised by the State Department with reference to the tobacco tax?

Mr. PAUL. With reference to cigars; yes.

The CHAIRMAN. Exclusively in regard to the cigars?

Mr. PAUL. Just cigars; yes.

The CHAIRMAN. That has been taken care of?

Mr. PAUL. The problem is being considered by the Treasury. That was the Cuban situation.

The CHAIRMAN. That was the Cuban situation?

Mr. PAUL. That is right.

Senator BARKLEY. I am going to make some further inquiry about this difference later on.

Mr. PAUL. I would be glad to supply that information. We haven't got our tobacco people here today, I am sorry to say.

Senator GUFFEY. Mr. O'Brien, on page 303, that difference in cigar prices, what have you to say in regard to that?

Mr. O'BRIEN. I am just coming to it, Senator. That is the new cigar rate, beginning on page 302, line 22, and running over to page 304, line 7.

Senator GUFFEY. What about those cigars that formerly sold at 2½ cents? What was the cigar tax on that?

Mr. O'BRIEN. At 2½ cents, Senator?

Senator GUFFEY. Retailed two for a nickel.

Mr. O'BRIEN. $2 per thousand.

Senator GUFFEY. You raised that how much? 50 cents?

Mr. O'BRIEN. $2.50 per thousand; yes.

Senator GUFFEY. The man who manufactured cigars for 4 cents, what was the former price on them? It is $3.50 now; and what was it formerly?

Mr. O'BRIEN. It was $2 and is made $3.50.

Senator GUFFEY. $2?

Mr. O'BRIEN. Yes.

Senator BARKLEY. May I ask how much increased revenue will this section 2,000 (a), on page 302, bring in? I do not want to delay it, but if you have it at hand I would like to have it.

Mr. O'DONNELL. $11.8 millions increase.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. The next change is the tax on cigarettes, page 304, line 8. The small or standard cigarette rate is raised from $3.25 per thousand to $3.50. The large cigarette is raised from $7.80 per thousand to $8.40.

Senator BYRD. May I ask, is that in accordance with the recommendation of the Treasury?

Mr. PAUL. It is not. The Treasury recommended a differential rate as between the cheap—well, the 10-cent cigarette and the 15-cent cigarette, but that was turned down by the committee.

Senator BYRD. What was the recommendation?

Mr. PAUL. The Treasury recommendation on the 10-cent brand was $3.50 as against the present $3.25. We proposed to raise the present $3.25 applicable to the 15-cent brands to $4. In other words, both brands get taxed $3.25 now. We proposed to raise the 10-cent brand to $3.50, and the 15-cent brand to $4, but the committee put a tax of $3.50 on both.

Senator BARKLEY. We had somewhat the same proposition up here some years ago, we put a graduated tax on cigarettes according to the price, and nearly all of the tobacco growers in my State came up here and protested against it on the ground that it drove down the price on the better grades of tobacco. I do not know what their attitude would be on this.

Mr. PAUL. There was a good deal of discussion on that point.

Senator TAFT. What does the language "tobacco or any substitute therefor" mean? What substitutes are there?

Mr. O'BRIEN. I do not know. It is old language.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 304, line 14, raises the tax on cigarette papers and tubes. Under the present law packages of cigarette papers or tubes containing not more than 25 papers or tubes are not taxed. This proposes a tax of one-half cent. Where the package contains more than 25 papers or tubes, or fractional part thereof, the tax is one-half cent for each 25 papers or tubes or fractional part thereof.

Subsection (e) imposes a floor-stocks tax equal to the increase in the rate of tax on the articles which are increased by this section.

Subsection (f) on page 306, line 9, permits additional sizes of packages for tobacco and snuff. Under the present law there was a limitation on the size can in which the tobacco may be packaged. This permits liberality in the case of the small cans.

Senator BARKLEY. Is that liberality toward the canner?

Mr. O'BRIEN. I understand the situation is this, that if the tobacco manufacturers can put up the tobacco in the smaller-size cans, they would still be able to sell the can of tobacco for the same price as the old can sold for notwithstanding the increase in the tax on tobacco.

Senator BARKLEY. That reduces the size of the can?

Mr. O'BRIEN. Yes.

Senator BARKLEY. And therefore the contents?

Mr. O'BRIEN. Yes.

Senator BARKLEY. The consumer gets less tobacco at the same price?

Mr. O'BRIEN. That is what they hope.

Senator BARKLEY. But the Government gets a little more of it?

Mr. O'BRIEN. I understand so.

Senator BARKLEY. The fellow that smokes gets stuck.

Senator CONNALLY. Gets smoked out.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. The next section, section 606, relates to the telephone and telegraph tax. Under the present law where the telephone toll charge is more than 24 cents, the tax is 5 cents for each 50 cents or fractional part of it. This tax is made an ad valorem tax of 20 percent on the amount that is paid. In cases in which the telephone subscriber is billed for the charge the tax applies to the entire amount of the charge under the bill and not separately to each of the items of toll charge. On telegraph, cable, and radio dispatches or messages, the tax has been raised from 10 percent of the amount paid to 15 percent of the amount paid. There has been a fundamental change in the whole telephone and telegraph tax. Under the present law the tax is paid on messages originating within the United States. This proposes a tax on the amount paid in the United States regardless of where the message originated.

The tax on leased wires, teletypewriter, and so forth, has been raised from 10 to 15 percent, and the tax on local telephone service for which a bill is rendered is increased from 6 to 10 percent.

Senator VANDENBERG. Is there any change in the definition of leased wires?

Mr. O'BRIEN. No; I do not think so, Senator—just a minute. Yes; my attention has been called to the fact that one of the double taxes under the leased wire taxes has been eliminated.

Page 310, line 4, section 607, photographic apparatus. The rate has been increased from 10 to 25 percent on lenses, photographic apparatus, and so forth, and on unexposed photographic films and plates, the rate has been raised from 10 to 15 percent. There have also been exempted from the tax cameras weighing more than 4 pounds exclusive of lens and accessories.

Senator VANDENBERG. What is that?

Mr. O'BRIEN. You remember that great debate about the big cameras in connection with the last revenue act.

Senator TAFT. Why is the camera tax so high, 25 percent? Is not that about the highest tax?

Mr. PAUL. It is. Well, it is one of the luxuries, and it is using a scarce material to some extent.

Senator TAFT. Twenty percent ought to be the highest put on that, instead of 25 percent.

Mr. O'BRIEN. Page 310, line 16, raises the tax on lubricating oils from 4½ cents a gallon to 6 cents a gallon.

Senator VANDENBERG. The Treasury is in favor of all these sales taxes?

Mr. PAUL. All these excise taxes, all except the freight and express.

Mr. O'BRIEN. Page 310, line 20, raises the tax on transportation of persons by ordinary coach and by Pullman from 5 percent of the price paid for the transportation to 10 percent of the price paid for the transportation.

Page 311, line 1, section 610, provides for a refund of tax in the case of organs, which are subject to the taxes on musical instruments that you put on last year, where the contract for the organ was entered into before October 1, 1941.

Section 611, page 311, line 9, terminates some of the excise taxes which you put on last year, first the tax on electric signs; second, the tax on rubber articles; third, the tax on washing machines of the commercial type; and, fourth, the tax on optical equipment.

Senator TAFT. Was that because of lack of yield?

Mr. PAUL. For instance, the electric sign tax seemed to be administratively impossible.

Senator TAFT. Have we got a table of the estimates last year on these sales taxes, and the actual result? Is there any way we get a comparison and see how the different ones worked out? It would be very interesting to have it and put it in the record.

Mr. PAUL. A comparison of the kind which you suggest, Senator Taft, is practically impossible to make and, if made, would not be meaningful. For these excise taxes, the repeal of which we now suggest, the estimates presented at the time of the passage of the revenue bill of 1941 were based on a full year of collections at the fiscal year 1942 levels of business. Since the Revenue Act of 1941 was effective October 1, 1941, with respect to these taxes, collections were received from November 1941, through June 1942. Of course, we could now make an estimate of what would have been received had the act been effective on June 1, 1941, but such a comparison would not be significant.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 311, line 22, relates to the affixing of cigarette stamps in foreign countries. It provides if the Government of a foreign country permits the stamps of that country to be attached in this country to cigars and cigarettes going there, then we will permit the attachment of our cigarette and cigar stamps in the foreign country to cigars and cigarettes that are coming here.

I understand it relates particularly to Cuba. The desire of the State Department is to permit the affixing of internal revenue stamps to cigarettes, and so forth, in Cuba.

Page 312, line 11, section 613, exempts the insignia, cap devices, chin straps, and so forth, for use in connection with the uniform of the armed forces of the United States from the jewelry tax. It also exempts from the jewelry tax smokers' pipes if the only part of the pipe which is made of precious metal is the part which is essential to the functioning of the device.

Page 313, line 1, section 614, exempts from the definition of "sale" water coolers the lease of which was made or renewed by the manufacturer or importer before October 1, 1941.

Section 615 exempts from the tax on business machines, cash registers of the type used for registering over-the-counter retail sales.

Senator CLARK. Is that a recommendation of the Treasury?

Mr. PAUL. It is not. One of the committee recommended that.

Senator DANAHER. Why should there be an exemption of cash registers and not business machines generally?

Mr. PAUL. I do not know any reason why there should, except that it was done.

Senator TAFT. Did the Treasury recommend the elimination of these other taxes?

Mr. PAUL. Yes; it did. You mean the rubber and electric signs?

Senator TAFT. Yes.

Mr. PAUL. Yes.

Mr. O'BRIEN. The next change, section 616, exempts from the tax on transportation of oil by pipe line certain what might be called local transportation within bulk plants or refinery or terminal plants if that transportation is not part of the through taxable transportation of oil.

Section 617 revamps the tax on so-called coin-operated amusement and gaming devices. The first major change is to include different kinds of amusement devices, not limiting it as the present law does to so-called pinball and similar amusement devices.

A further change is that in the case of a vending machine which operates by means of the insertion of a 1-cent coin, if that dispenses a prize of the value of not more than 5 cents, then it is to be classified at the $10 rate rather than the $50 rate. In other words, it is not a gaming device; it is classified as an amusement device.

Senator BYRD. Has the rate of tax been changed?

Mr. O'BRIEN. The rate of tax has not been changed.

Senator BYRD. What is the tax?

Mr. O'BRIEN. $10 and $50; $10 on the amusement devices, and $50 on the slot machines.

A further amendment provides that there shall not be a requirement that there be posted a list of special taxpayers who pay the tax on the slot machines. Under the present law it is required that there be posted in the collector's office a list of all taxpayers who are paying a special tax; that is, an occupational tax. This says that that list shall not include those paying the slot-machine tax.

Page 315, line 11, section 618, imposes a tax of 5 percent on the total amount that is received in the pari-mutuel or totalizator pool.

Senator DANAHER. When you say "total amount," does that include breakage?

Mr. O'BRIEN. I do not know, Senator. I do not know anything about that.

Senator TAFT. You mean they go broke?

Senator DANAHER. I do not know.

Mr. SURREY (Stanley Surrey, Assistant Legislative Counsel, Treasury Department). I could explain that.

Senator BARKLEY. What breakage are you talking about? Is it financial or physical?

Mr. SURREY. The tracks pay off in even multiples of 10 cents or 5 cents. The difference between the odd amount of pennies and 5 and 10-cent multiples is generally retained by the track, and that is what is called breakage.

Senator CLARK. What is the revenue?

Mr. PAUL. A little over $23,000,000.

The CHAIRMAN. All right, Mr. O'Brien.

Mr. O'BRIEN. Page 316, line 17, relates to sales under chattel mortgage.

Senator TAFT. One other question I had in mind. Is there any other means of wagering? Supposing you had an old-style race track and wagering—there may not be any left; I don't know—does this discriminate against the pari-mutuel?

Mr. TARLEAU. Yes; it does to the extent there are other types of betting going on. This is the one that is capable of administration. Chasing around to the pool halls, barber shops, and so forth, for a tax on those other types of wagers would be impossible.

Senator TAFT. I was wondering whether the race track shifted over from the pari-mutuel to some other system.

Senator BARKLEY. What is the totalizator? Is that where you total the horses?

Mr. PAUL. I am afraid our specialist will have to answer that.

Mr. SURREY. That refers to the machine which performs the computations.

Mr. O'BRIEN. Page 316, line 17, section 619 provides that where, under the existing excise taxes, an article is sold under chattel mortgage arrangement providing for the payment of the sales prices in installments, then instead of collecting the tax on the amount of the sale at the time when the sale is made, on the entire amount, you collect the tax on the installments as they come in. In short, it provides the same treatment as it provided in the case of a conditional sale. I understand in some States they do not have a system of conditional sales, but have a chattel mortgage arrangement which is very similar to it. You pay the tax on the installments and not on the total amount at the time the article is sold.

Page 317, line 7, repeals existing taxes on the occupation of being engaged in the manufacture of mixed flour and on the manufacture and sale of mixed flour.

Senator CLARK. Is that the same old controversy about mixed flour?

Mr. O'BRIEN. I understand that has all died out, Senator.

Page 317, line 11, is the tax on the transportation of property. It is a tax equal to 5 percent of the amount paid for tranportation, except that in the case of coal the tax is 5 cents per long ton. The tax is to be paid by the person paying for the transportation. The tax applies only where the transportation charge is paid to the person engaged in the business of transporting property for hire, and where the payment is made to a freight forwarder the tax is on the amount paid to the freight forwarder, but there is no tax on the amount paid by the freight forwarder to the transportation company.

Senator BYRD. How much revenue does that bring in?

Mr. PAUL. $163,000,000 on a net basis. By that I mean when you charge this tax you must take into consideration a deduction for other purposes. That is the true way to figure it.

Senator BYRD. The Treasury is opposed to it?

Mr. PAUL. It is.

Senator CONNALLY. It is opposed to the tax, you mean, on transportation?

Mr. PAUL. Our reason for being opposed to the tax is we have been told by O. P. A. it would interfere very seriously with price ceilings.

Senator VANDENBERG. You were also told by W. P. B. when you went over 80 percent on excess-profits taxes it would interfere with the war effort?

Mr. PAUL. That is why we came in here with a proposal for the post-war credit.

Senator BARKLEY. What does this transportation tax return in money?

Mr. PAUL. About $163,000,000 on a net basis.

Senator DANAHER. Mr. Chairman.

The CHAIRMAN. Yes, Senator Danaher.

Senator DANAHER. When do we expect to take up supplement U, commencing at page 159?

The CHAIRMAN. We are waiting for Mr. Rice.

Senator CONNALLY. Is that all on the excise taxes?

Mr. O'BRIEN. That is all.

Senator CONNALLY. I certainly want to express my appreciation. I do not find any excise tax on husband and wife in community property.

The CHAIRMAN. Is Mr. Rice here now?

Mr. O'BRIEN. I hoped he would be here before now.

The CHAIRMAN. Mr. Rice did not come in. Could you explain it?

Mr. O'BRIEN. I do not know enough about it to explain it.

The CHAIRMAN. What is this? The withholding provision?

Mr. O'BRIEN. Yes.

Mr. PAUL. If you want to go on, or I think Mr. Tarleau or Mr. Stam could explain it.

Mr. O'BRIEN. We might take up a few more things in connection with the freight taxes.

First, transportation by or for the United States is exempt, and, second, whereas the other amendments in this title go into effect the 1st day of the first month which begins more than 10 days after the date of the enactment of the act, this tax is postponed to the 1st day of the first month which begins more than 30 days after the date of the enactment of the act. It gives a little more time to prepare for this tax.

Furthermore, everybody who engages in the business of transporting property for hire is required to register with the collector of internal revenue in the district in which his principal place of business is located.

I think that is all in connection with this.

I understand Mr. Rice is on his way.

The CHAIRMAN. Is it the pleasure of the committee to hear Mr. Rice and then adjourn until Monday?

Senator BARKLEY. Yes.

The CHAIRMAN. Senator Davis wished to ask the Treasury a question.

Senator DAVIS. Mr. Paul, yesterday I happened to be out of the committee meeting when you were discusssing the section relating to the taxable years embracing the calendar years. In regard to these changes, I would like to ask the Treasury whether the accounting difficulties of the Treasury would be greatly increased under this change in the law?

Mr. PAUL. I do not know whether I would use the word "greatly," but they will certainly be increased.

Senator DAVIS. How much? Can you give us an estimate on that?

Mr. PAUL. It is pretty hard to estimate accounting difficulties, but there will be a considerable amount of new work that has to be done on returns to be filed. However, it seems to me that those difficulties and the other more serious problems in connection with that section—by the more serious problems I refer to the fact that the people have committed themselves on dividends and inventory problems—are probably worth the fairness that is achieved and the additional amount of revenue that is derived.

Senator DAVIS. Inasmuch as there is a shortage of help around here, would not there be some advantage to the Treasury in trying to stagger it?

Mr. PAUL. We do not have any requirement in this section depriving taxpayers of the fiscal year. All this section does is put the fiscal-year taxpayers on a par with the calendar-year taxpayers. There is no attempt—I want to make this clear—to say to taxpayers: "You cannot use the fiscal year any more."

Senator TAFT. "You can have it, but!"

Mr. PAUL. That water is pretty much over the dam, Senator. If you have a fiscal already established, then you are up against this rule and you are depending on what the committee does.

The CHAIRMAN. All right, Mr. Rice, if you will explain to us briefly the provisions of supplement U on page 159 of the bill.

STATEMENT OF STEPHEN E. RICE, OFFICE OF THE LEGISLATIVE COUNSEL, UNITED STATES SENATE

Mr. RICE. This is the supplement that provides for collection at the source on wages, bond interest, and dividends which are includible in gross income. It applies only to individuals, partnerships, trusts, and estates. It does not apply to dividends or bond interest paid to corporations or other organizations which are exempt from tax.

The problems the Bureau expects to encounter in administering the supplement are similar in a great many respects to the problems they have encountered in connection with social-security taxes. In one respect the problem under supplement U has greater administrative complexity than under social security because the supplement U tax is merely a collection device and if at the end of the year $50 has been withheld from the wages of an individual but because he was laid off during the year or because he suffered a large deductible loss and had no tax liability, the $50 withheld at the source would have to be refunded to him. There is no such problem under the social-security taxes since an employee's wages are subject to the tax whenever they are paid and the tax money goes into a trust fund to pay him benefits in later years.

The supplement has 8 sections beginning with section 425 and ending with 432. Section 425 contains the definitions used in the supplement.

Section 426 contains the requirement of withholding 5 percent in 1943 and 10 percent thereafter.

Section 427 contains the rules for determining the status of individuals for purposes of the withholding deduction, whether they are married, single, or head of a family. The cases where both husband and wife work. The rules applicable when the status is changed.

Section 428 specifies the person who is required to withhold the tax and includes officers and employees of the United States and the States.

Section 429 requires the withholding agent to make return and pay the tax quarterly.

Section 430 deals with receipts required to be furnished the employee by his employer showing the wages paid and the amount of tax withheld and collected. Employers of less than eight are required to give a receipt each pay day and also a receipt at the end of the year covering the whole year. Employers of eight or more are required to give the receipt only at the end of the year. The theory upon which the

smaller employer must give a receipt with each payment of wages while the larger employer must give it only once a year is based upon the fact that as a general rule employment is steadier with the larger employer. His bookkeeping is more efficient. There are not so many "fly-by-the-night" larger employers. The experience under social security led the Bureau to recommend that smaller employers give the receipt with each payment of wages.

Section 431 requires every employee to furnish withholding deduction certificates to his employer showing whether he is single, married, or a head of a family, so that the employer will be able to compute the withholding deduction and thus be enabled to withhold the correct amount of tax.

Section 432 provides for a fine of $1,000 and 1 year and a civil penalty of $50 if the withholding agent refuses to furnish receipts to his employees or furnishes false ones. It also provides a $500 fine and 1 year where the employee willfully fails to furnish the deduction certificate to his employer or willfully supplies false information with respect to it.

Senator VANDENBERG. Does not this involve a tremendous bookkeeping burden on the part of every employer and the Government itself?

Mr. RICE. Not too much in addition to what they already do, Senator.

Under title II of the Social Security Act, as you know, that covers one employee or more. All of the employers have had 7 years' experience with that, and they will be in a much better position to do this job than they were to do the social security job back in 1936 when it first went into effect.

Senator VANDENBERG. Yes; but they are in the position where the multiplicity of work placed on them by the Government is just about ready to break their backs.

Mr. RICE. This will be an added burden; there is no question about that.

Senator BARKLEY. To what extent will this change involve the amount of revenue collected?

Mr. RICE. I think you will have to call on the Treasury for that information.

Mr. PAUL. This will not change the amount of revenue in one sense. Let me make this clear. This is not an additional tax, a withholding tax, it is a collection in advance.

Senator BARKLEY. It will make a difference, whatever difference it will amount to between getting it at the source and running the risk of not getting it at all at the end of the year.

Mr. PAUL. There is that risk, that is right. We cannot estimate that. What I can say in answer to your question is we will collect an advance payment of one and one quarter billion under the 5 percent and two and one-half billion under the 10 percent of the following year.

Senator VANDENBERG. Will it not involve a tremendous additional administrative expense to you?

Mr. PAUL. It will certainly involve an additional administrative expense. Whether it is tremendous is a problem that has to be worked out.

Senator TAFT. How many withholding agents will there be?

Mr. PAUL. You mean withholding agents in a nontechnical sense? That is the person who investigates these returns?

Senator TAFT. No; how many will collect the taxes and pay them to the Government for somebody else?

Mr. RICE. All the employers of the country.

Mr. PAUL. About two and one-half million employers.

Senator TAFT. How many employees? 50,000,000?

Mr. PAUL. I am told something like 27,000,000 persons would have taxes withheld at the source. There is exempted from this, farm labor and domestic labor, so that, together with the exemptions allowed before withholding begins, cuts down the number to a very large extent.

Senator TAFT. There will be two and one-half million more returns. How often do they pay it over to the Government?

Mr. RICE. Quarterly.

Mr. PAUL. Quarterly.

Senator TAFT. There will be 10,000,000 new returns practically over what they have now.

Senator VANDENBERG. Is the Treasury in favor of this provision?

Mr. PAUL. It is very much in favor of it. It regards it as extremely important.

Senator CLARK. This is not a revenue measure.

Mr. PAUL. It is definitely important from the anti-inflationary standpoint. It is also important in the sense which is suggested by Senator Barkley, in that we will collect some money from people who would not otherwise make any report on income. We cannot get those fellows unless we have the collection-at-the-source method.

It is important in another sense, because with our tax rates going up, it is important that the taxpayers get on a current basis with respect to the payment of their taxes.

Senator CLARK. They pay 2 years' taxes in 1.

Mr. PAUL. That is why we made it only 5 percent the first year.

Senator TAFT. Or 3 years' taxes in 2.

Mr. PAUL. We tried to meet that problem by having the first year only 5 percent, in order to get over the hump of the first year.

Senator TAFT. It seems to me we are permanently adding to the revenue during the war $2,500,000,000. I cannot see why that money for all time to come will not be an additional $2,500,000,000. It will serve the purpose of an additional $2,500,000,000 tax.

Mr. PAUL. That is true. We have the large number of returns provided for under this bill, something like 30,000,000 returns filed, and it seems to me it is absolutely essential to the operation of the tax that we have this system in the bill.

Senator CONNALLY. Mr. Paul, I readily agree with your theory that a good many taxes will be gotten this year that would not otherwise be gotten, because the taxpayers in the lower brackets have never been used to paying taxes, do not know about it and would not pay it; but, on the other hand, I understand there are 150,000 delinquents in the social-security taxes of employees. Is that true?

Mr. PAUL. Yes; that is right.

Senator CONNALLY. A similar situation probably would obtain in this respect.

Mr. PAUL. We will have a delinquency problem, Senator Connally.

Mr. RICE. Senator—if I may interrupt there, Mr. Paul?

Mr. PAUL. All right.

Mr. RICE. There is one difference between the social-security employer not paying and an employee under the withholding system not paying, because the employer at the end of the year has to pay an income tax anyhow, if he is taxable. You might say he is putting it in a savings bank until the time comes to figure his tax liability.

Senator CONNALLY. He is allowed a deduction, of course, on whatever he has paid.

Mr. PAUL. If the employer withholds it; yes.

Senator BYRD. What you do is that in 1943, for example, he has got to pay the 1942 tax, and then he pays the 5 percent in 1943 on his income in 1943. That pyramids it.

Mr. RICE. Then, on March 15, 1944, he is entitled to deduct from his tax liability then payable the amount withheld in 1943.

Senator BYRD. It does change the collection in the sense that it anticipates it.

Mr. RICE. That is right.

Senator BYRD. Because, otherwise, under normal conditions he would not pay his 1943 tax until 1944—March 15, 1944.

Mr. RICE. That is right.

Senator BYRD. I want to ask Mr. Paul of the Treasury if they have made an allowance for that additional income that would come in 1943 by reason of this anticipation within that calendar year?

Mr. PAUL. Yes; that affects our estimate when you come to collection basis.

Senator BYRD. I mean, have you in your estimates of revenue to be derived in the next fiscal year made that allowance?

Mr. PAUL. Yes. Mr. O'Donnell said yesterday that the added yield of the House bill on the collection basis was a little over $4,000,000,000, and in the second half of the fiscal year this collection will be in operation—collection at the source will be in operation—if this bill is adopted. That has been taken into account.

Senator BYRD. What will be the revenue from this 5 percent that you collect in 1943 on the 1943 income?

Mr. PAUL. A billion and a quarter.

Senator BYRD. Then the next year you have the same performance, except you make it 10 percent?

Mr. PAUL. That is right; that will make it two and one-half billion then.

Senator BYRD. That is an anticipation of revenue which normally would not come in until the next year.

Mr. PAUL. Almost a year later. It brings the revenue in practically a year earlier than under the present system.

Senator BARKLEY. After you get started out on a dead level, you collect practically the same every year, assuming the wages would be the same.

Mr. PAUL. That is right, if the rate would be the same.

The CHAIRMAN. Was this withholding rate of 5 and 10 percent recommended by the Treasury?

Mr. PAUL. It was.

Senator BYRD. Now, this billion and a quarter additional that will come in the calendar year 1943, that has been allowed for in your revenue estimate as an income?

Mr. PAUL. Yes.

Senator BYRD. How much will that increase the income in 1943 for this entire bill?

Mr. O'DONNELL. As I understand it, the tax is to be collected by the withholding agents currently and returned to the Treasury quarterly. In one of the tables which I introduced yesterday in the record as exhibit G, you will find a footnote which shows that of the individual income tax collections of $6,840,000,000 in the fiscal year 1943, the receipts of the withholding tax in respect of calendar year 1943 incomes which are included amount to $319,800,000. That represents the receipts of 3 months' withholdings on 1943 calendar year incomes as the first quarter's withholdings are all that will be received during the fiscal year 1943. We have not attempted to forecast business and income levels beyond the fiscal year 1943, but if we assume that the same levels prevail in calendar year 1943 as are forecast for fiscal year 1943, then the withholdings for a whole year would amount to $1,285,000,000, and that will not all be received by the Treasury until the first quarter of calendar year 1944.

Senator BYRD. There will be a greater anticipation in the fiscal year 1944. You get four quarters.

Mr. O'DONNELL. That is right. You get receipts of one quarter's withholding at the 10-percent rate so that the Treasury will receive about $1,600,000,000 withholdings during fiscal year 1944, although as I have said we have not attempted to forecast accurately that far ahead. Of course the $1,285,000,000 withheld during 1943 is an offset reducing the payments due in fiscal year 1944 on calendar year 1943 incomes. The end result is receipts of 3 month's withholdings at the 10-percent rate or some $600,000,000, but credit against the March payments included some $300,000,000 withheld and received in the previous fiscal year so that it results in a net additional increase of some $300,000,000 in individual income tax collections during the fiscal year 1944.

Senator BYRD. Your estimates have allowed for that?

Mr. O'DONNELL. That is correct, as Mr. Paul describes it, on the collection basis for fiscal year 1943, which is as far into the future as we have forecast. All future Budget estimates would take collection at the source into account if this method becomes law.

Senator BYRD. Your position is—and I assume it is correct—that this is an anticipation and not an additional revenue?

Mr. O'DONNELL. That is correct. It is another way of collecting a tax, the liability for which is fixed by law now.

Senator DANAHER. Mr. Chairman.

The CHAIRMAN. Yes; Senator Danaher.

Senator DANAHER. I would like to ask Mr. Paul if we have authority in the law to hold liable, under threat of a penalty, the officers of a State, Territory, or political subdivision thereof, who refuse to withhold?

Mr. PAUL. Well, we have discussed that question. Maybe we do not. I do not expect any violent opposition from these people. I think it can be worked out on a cooperative basis if we have not that technical capacity.

Senator DANAHER. So you would really anticipate being able to achieve a cooperative effort?

Mr. PAUL. That is right.

Senator DANAHER. Now, with reference to the matter of bond interest as one of the items in the tax collected at the source, suppose that a local political subdivision litigates the question of whether or not the bond interest should be withheld and refuses thereafter to withhold in an assertion of its own rights?

Mr. RICE. That is not includible in gross income, Senator. That will not be subject to withholding. You are talking about municipal bonds now?

Senator DANAHER. Yes.

Mr. RICE. If the interest on such bonds becomes taxable and is required to be included in gross income, such interest will fall in the same category as State salaries and will be subject to withholding.

Senator DANAHER. On page 160, lines 14 and 15, you say, talking about bonds: "including those issued by a Government or political subdivision thereof, or any agency or instrumentality."

Mr. RICE. That is right. Now, look on page 161, the next page, the requirement about withholding down at the bottom of the page.

Mr. DANAHER. I see.

Mr. RICE (reading):

> There shall be withheld, collected, and paid upon all dividends, bond interest, and wages of every person, to the extent that such dividends, interest, and wages are includible in gross income.

Municipal bond interest is not.

Senator DANAHER. You are definitely excluding that?

Mr. RICE. Yes, sir; because it is not includible.

The CHAIRMAN. What about in the case of the New York Port Authority, or some other instrumentality?

Mr. RICE. If that is includible in gross income, it is subject to withholding.

The CHAIRMAN. Suppose it claims it is not, and the Treasury claims it is; then you have a lawsuit.

Mr. RICE. That is right.

The CHAIRMAN. Then what are you going to do in the meantime? Are you going to penalize them?

Mr. TARLEAU. They would be liable or they would not be liable.

The CHAIRMAN. It says: "willfully refusing."

Mr. TARLEAU. "Willfully" would mean plainly in disregard of the law and regulations without color of right.

The CHAIRMAN. In other words, he refuses at his peril.

Mr. TARLEAU. No; "willfully" would mean recognizing his responsibilities under the statute but not caring to comply with the statute. "Willfully disregarding the act of Congress," that would be the type of willful disregard that the statute contemplates.

The CHAIRMAN. I was referring specifically to the penalty section.

Mr. TARLEAU. Certainly you were. I know that point has already arisen, but a willful disregard would be just a contemptuous defiance of the act of Congress. You know there happened certain instances of that in the past, persons who were just willfully disregarding the requirements of the statute.

Senator BARKLEY. In other words, knowing what his duty is he refuses to perform it.

Mr. TARLEAU. Certainly, but denying that he has a duty and denying that the statute applies to him is an altogether everyday occurrence. People very frequently contest the Treasury's position or deny the act is constitutional as to them. If they have a color of right, of course it is not willful. Willful is used in the sense of where a person knowing his responsibility disregards it.

The CHAIRMAN. Where they have a bona fide dispute as to whether they are liable, then you do not think they can be classified as doing that willfully. If it is a bona fide question, where the courts have not settled it and he in good faith raises the issue, you would not regard that as justifying the imposition of a penalty?

Mr. TARLEAU. Certainly not. As has been pointed out, if you wilfully fail to file a return on a matter which is subject to tax, of course, it is subject to penalties. We have the question of taxability under the statute now of holders of these Port of New York Authority bonds. If they do not pay a tax on the bond interest, and they claim under the statute that they are not subject to tax although we claim they are, and they do not include bond interest in their income, of course, they are not subject to penalty. As I have indicated, they have a claim which defeats any claim that they are willful.

The CHAIRMAN. That would be my interpretation of it. I wanted to see whether that is the Treasury's attitude about it.

Mr. PAUL. I do not think there is any question about it.

Senator TAFT. Mr. Chairman, is not this thing going to be infinitely more complicated for the employers than under social security, asking them to allow these exemptions every week, figuring out what must be deducted? It seems to me it is going to be much more difficult for the employers than anything we have under social security, which is just a flat rate on everything they pay.

Mr. RICE. Senator, the scheme in general is that the employee will file a withholding deduction certificate, which will be printed here in Washington and sent out by the Treasury to all employers. It will show whether he is single, whether he is married, whether he is the head of a family, and it will show his dependents. That will be filed with the employer at the beginning of the pay-roll period. The only thing the employer's bookkeeper has to do is look at that and then go to the table which is set out on page 162 to find out how much he will have to withhold over and above the withholding deductions that are set up in that table. For instance, if a man is single he will so indicate on his certificate that he files with the employer. If he has a weekly pay-roll period, the employer will withhold on that part of his wages which exceeds $11.

Senator TAFT. It makes an awful difficult job to get those certificates. That would be a perfectly tremendous job. A man that has 5,000 employees, he will just be hammering day and night to get them out.

Mr. RICE. If he does not, then the employer treats them as a single person and he withholds everything over $11, no matter whether he is married, no matter how many dependents he has.

Senator TAFT. If he is getting $50 that week and he deducts $11, that leaves $39.

Mr. RICE. He withholds $3.90.

Senator TAFT. He has got to figure 5 percent on that. Each week you pay them different amounts because they work different hours, so it has to be figured each week as to what the withholding is going to be.

The chief reason I would be opposed to it, it seems to me, is that it almost eliminates the possibility of a compulsory savings plan, which I think we must come to in the case of bonds. I do not think we can duplicate a withholding tax. The only way I can see whereby you can work out a possible savings plan would be to withhold.

Mr. RICE. These people way down in the lower-income group of $11 a week are not going to be able to buy bonds anyhow, with the higher cost of living and the higher taxes being imposed; they just cannot buy bonds.

Senator TAFT. They cannot pay taxes either.

Mr. RICE. They cannot do both. This will help them to pay their taxes.

Senator TAFT. This is based apparently on the theory that the total pay roll that is going to pay the taxes will be only $25,000,000,000. That seems to be the basis of the figures. Whereas we know the total pay roll of the country is going to be $75,000,000,000. So these deductions, when you get through, are going to be taken from one-third of the pay roll, although the complication of calculating them is a tremendous complication. Is not that correct? I mean, when you get all through you deduct about one-third of the pay roll.

Mr. PAUL. That is about right. I want to go back, however, to a previous statement you made, Senator Taft, that this would be a bar to the compulsory savings plan, if it should be necessary to adopt that. It seems to me that quite the contrary is the case. This sets up the machinery which will facilitate the operation of a compulsory savings program if it should be necessary to put such a program into effect.

The CHAIRMAN. If you could raise your percentage of withholding to 10 percent or 15 percent and go away from your normal on your individual income, you would have that system set up?

Mr. PAUL. Yes.

Senator TAFT. It seems to me if you would just take a flat 5 percent from everybody, as the social security does, and let the social security do it, you could work it with half the machinery.

Mr. RICE. The social security does not collect those taxes, Senator.

Senator BYRD. What classes are exempt?

Mr. PAUL. Agricultural workers and domestic servants.

Senator BYRD. Where does the difference between the 25,000,000,000 and the 75,000,000,000 go? Where is that 50,000,000,000 exemption?

Mr. PAUL. Anybody who gets below these exemptions enumerated here, depending on the status of the employee. For instance, a married person with dependents making less than $26 a week would not get any withholding.

Senator BYRD. As a matter of fact, is not this true, Mr. Paul: That the anticipation of this really gives you $1,250,000,000 additional revenue?

Mr. PAUL. In one sense it does, in that the year following you are constantly ahead of the game, too.

Senator BYRD. You are still anticipating?

Mr. PAUL. That is right.

Senator BYRD. This will give you, even through the period of 10 years—it will give you $1,250,000,000 more revenue than what you would otherwise get?

Mr. PAUL. If business goes bad it starts to go in the other direction and you would have an effect in reverse.

Senator BARKLEY. That only applies for the 1 year.

Senator BYRD. It applies constantly.

Senator BARKLEY. It comes off the next year's taxes.

Senator BYRD. You get the taxes the next year.

Mr. PAUL. You are always a year ahead on the collections.

Senator BARKLEY. You are a year ahead on the collections but you are not ahead on the liability.

Mr. PAUL. In the sense of liability, you are not ahead; in the sense of collection you are ahead.

Mr. TARLEAU. If this fellow from whom you collect the 5 percent becomes unemployed, within the year of unemployment under the existing system you still get the taxes of the prior year, which is one of the reasons we like this new system. Under this system in a year of nonemployment you will not be collecting the 5 percent.

Senator BYRD. Assuming the same level of employment, you would be getting in actual cash $1,250,000,000 more than you would otherwise get over a period of years.

Senator TAFT. Two and one-half billion more.

Senator BARKLEY. You do not get any more money, simply because you collect in advance.

Mr. PAUL. You are always ahead a year on the collection basis.

Senator CONNALLY. Is it not just like the fellow who rents an apartment and pays $25 in advance, and when he pays the balance he does not pay the $25 that he has already paid?

Mr. PAUL. That is because in your example, Senator Connally, when your lease terminates you get credit for the $25. But the Senator is right in respect to the thought that you are always, on the collection basis, so much ahead.

Senator CONNALLY. You are not getting so much total revenue more. The revenue you would be anticipating this year you would get next year.

The CHAIRMAN. You get another anticipatory payment each year. If we pay the taxes in advance currently, it is all right until you come to the end some place. You finally lose something somewhere.

Senator VANDENBERG. How does the employee get his refund if he gets some back?

Mr. RICE. He is given a receipt by the employer on each payment of wages, or at the end of the year, or upon termination of employment. That receipt is filed with his return to show if too much was deducted. For instance, if he has only worked half the year, the employer deducted only during the first 6 months that he worked; and, since he did not work for the other 6 months, he would have no tax liability. He will file his receipt with his return, and, if the amount

of the refund is $50 or less, it is paid to him immediately. If it is more than that, it takes the ordinary course of refunds.

Senator VANDENBERG. That would be 3 or 4 years?

Mr. RICE. I don't think they are that far behind.

Senator TAFT. Looking at it from the point of view of the work that is involved, you are imposing a new 19-percent income tax, and this has the effect of making it 24 percent next year; as far as I can see it is a tremendous increase on the individual workman.

Mr. PAUL. It has the effect of increasing the payment next year to 24 percent. That is 19-percent liability for the previous year and 5 percent out of the current year.

Senator RADCLIFFE. How would you reckon the amount of taxes paid on this bill that might be deducted? When would the accounting come in on that?

Mr. RICE. You would withhold during the calendar year 1943 5 percent of his wages, all through the calendar year 1943; then, when it came to paying his income tax on March 15, 1944, for his 1943 income, he would look to see, as evidenced by the receipts that his employer gave him, how much had been withheld. Say, for instance, $25 had been withheld during the calendar year 1943 and his tax liability was $100, he would owe the Treasury at that time $100 minus the $25, or $75. There will be a space on these income-tax returns to show the credits, and he will just fill in that amount and then deduct it from his tax liability.

Senator TAFT. How many employees would it take in the Treasury Department to run this show?

Mr. RICE. It has been estimated between 8,000 and 10,000.

Senator TAFT. From 8,000 to 10,000?

Mr. RICE. Additional employees.

Senator CONNALLY. Just on this one item alone?

Mr. RICE. Yes, sir.

The CHAIRMAN. Are there any further questions of the Treasury at this time, or shall we now recess until Monday at 10 o'clock?

Senator VANDENBERG. The next year sometime.

The CHAIRMAN. No; Monday at 10 o'clock. Mr. Rice, you will be designated as the expert on this particular division.

(Whereupon, at the hour of 1:25 p. m., the committee recessed to 10 a. m., Monday, July 27, 1942.)

REVENUE ACT OF 1942

MONDAY, JULY 27, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order. Mr. Seidman, you are listed as the first witness this morning. You may proceed.

STATEMENT OF M. L. SEIDMAN, CHAIRMAN, TAXATION COMMITTEE, NEW YORK BOARD OF TRADE, NEW YORK, N. Y.

Mr. SEIDMAN. Gentlemen, I am appearing here as the chairman of the taxation committee, New York Board of Trade.

The obvious reaction to a tax bill that is to raise $6,000,000,000 to meet a 1943 deficit of nearly $60,000,000,000 is that it is totally inadequate.

This is not to say that the tax bill now before you gentlemen fails to dig deeply into additional sources of revenue. It does, in fact, go to the limit of endurance for many who are already carrying a terrific tax load.

What it fails to do is to bring in everybody who can and should share the burden. Instead of 7,000,000 new taxpayers, this bill should produce twenty-five or thirty million new taxpayers. It could do it either by removing all exemptions or by a sales tax.

No one need worry about wartime millionaires under this bill. There is one person in this country who in 1940 reported a taxable income of $5,000,000. Under this bill, his Federal tax would be $4,374,616, and if he happens to live, say, in California, his State tax would be $740,590, making a total tax of $5,115,566 on his $5,000,000 income.

If this man, on a cash basis, were smart enough to prepay some of the State tax, he might perhaps be let out with an even $5,000,000 tax on his $5,000,000 income, but anyone who is dumb enough to have a $5,000,000 taxable income, would not be smart enough to come in out of the rain. For, if this man had only a million dollar income, he would actually be permitted to keep $4,000 of it instead of ending up $115,566 behind the eight ball. At any rate, it is obvious that incomes in this class can be crossed off the list if we are looking for more taxes.

On a $100,000 income under this bill the Federal tax is $65,000 and the top rate is 83 percent. Even at $10,000 the rate is 38 percent and at $26,000 it is 61 percent. Here, too, then, it is obvious that the proposed rates are exceedingly high and that after their imposition, even moderately large incomes will no longer exist. If all incomes over $25,000 were completely confiscated instead of being taxed as proposed under this bill, I estimate the Government would collect an additional $500,000,000, which is less than 1 percent of the $53,000,000,000 deficit. It should thus be clear enough that additional revenue in any sizable amount can come only from income sources not now taxed.

While this bill goes all out in taxing our middle and upper classes, it completely exempts from income tax more than 60 percent of our families, about half the number of our wage earners and more than half of our total national income. Here, then, is its major defect. Our able Secretary of the Treasury, in his excellent statement made before you gentlemen last week, stated it to be his conviction that the people of this country want a courageous tax bill and that they are ready to make greater sacrifices than some of us imagine.

I propose, for the duration, a 10-percent war tax on every dollar of net income that is exempt under this bill because of personal exemptions or credit for dependents. This is to be conditioned upon the present normal tax remaining at 4 percent instead of the proposed 6 percent. I estimate that the net result would be an additional $5,000,000,000 in revenue. In the alternative, I propose a sales tax to raise about the same amount.

Coupled with this, there should be removed the exemption now enjoyed by tax-exempt securities. No exempt securities should hereafter be permitted, and exemption of those already outstanding should be removed for the duration. While it is undoubtedly true that investors have bought these securities on a low-yield basis, so that they are in effect already paying a tax on the income, it is nevertheless in the interest of morale, especially when people with small incomes are required to make great sacrifices, that this exemption be removed.

Senator VANDENBERG. Do you dismiss the constitutional question, or are you satisfied that there is no constitutional question?

Mr. SEIDMAN. I am satisfied there is a constitutional question that will be before the Supreme Court very shortly in the *New York Port Authority case* and they will decide that for us.

Senator BARKLEY. You do not want to wait until they decide it, you want to go ahead now?

Mr. SEIDMAN. I believe there is a doubt. I believe we have passed legislation here before on the basis of the supposition that it is constitutional.

Senator BARKLEY. Let me ask you this question. I am asking the question in good faith. Where a Member of Congress has an honest doubt about the constitutionality of a measure, he may vote for it with those reservations, understanding, of course, that the courts will have to pass upon it, but where a Member is convinced in his own mind that an act is unconstitutional, do you think he ought to vote for it regardless of that?

Mr. SEIDMAN. I do not think so.

Senator BARKLEY. I agree with you.

Mr. SEIDMAN. Thank you, sir.

Senator BROWN. Mr. Seidman, does this represent a change from the former attitude of your association?

Mr. SEIDMAN. No; we have always been for the removal of tax exemption on securities.

Senator BROWN. I did not know that.

Mr. SEIDMAN. Yes, sir. I have repeated that before this body for some years past.

This bill proposes to withhold at the source the income tax on wages, dividends, and bond interest at the rate of 5 percent in 1943 and 10 percent thereafter. The stated objective is to retard inflation and to collect tax now escaping through sheer failure on the part of the recipient to report it as taxable income. As to wages, however, only a tax on income above exemptions is to be withheld. The employer is accordingly required to give effect to a pro rata credit for personal exemptions and dependents with every payment and every withholding. He is made the Government's tax collector, bookkeeper, and custodian. In addition, he is required to obtain a certificate from each employee as to his or her marital and dependency status, and to give a receipt for all taxes withheld. Receipts are also called for in connection with each dividend and interest item paid, and, of course, all withholders must file detailed returns and regularly pay over the tax withheld.

Because of the strictly prescribed nature of the income to be withheld, careful definitions and minute rules are laid down covering master and servant relationship, and the treatment of such items as commissions, bonuses, profit-sharing arrangements, and so forth.

Payments to independent contractors, individuals in the professions or in business, also come in for detailed treatment. The whole scheme is so elaborate and is bound to impose such a terrific burden upon business already overwhelmed by governmental requirements, that this newest of proposals seems entirely out of gear when considered in terms of additional revenue or in terms of arresting inflation.

If any taxable income under present law escapes tax, it can readily be discovered by a check against the Government's social security records or by tightening up the reporting machinery now in operation. Every income payment instead of only those above certain exemptions could be reported. And as to the effect upon inflation, considering the rate of withholding and the exclusions for personal exemptions and deductions, the plan does not seem worth the candle. Possibly the implication made here the other day that this would set up machinery for a compulsory savings plan throws some needed light on the subject.

For a more effective check on buying power, as well as for getting the revenue more quickly into the Treasury, I suggest that all income and excess-profits taxes—and I mean income and excess-profits taxes of corporations and income taxes of individuals—be hereafter payable in monthly instead of quarterly installments. For what is still uncollected for 1941 and due next December, the first monthly installment can begin with October 1, 1942. Similar payments can be made on November 1 and December 1, 1942.

Beginning with January 1, 1943, and monthly thereafter, all taxpayers could be required to remit one-twelfth of their estimated self-calculated tax liability for the year 1942, until their actual liability is determined through their filings of a timely 1942 return.

After that, they can continue to pay monthly installments on an actual liability basis. Or, January and February can be passed by and beginning with March 15, 1943, and monthly thereafter, payments can be made on an actual liability basis.

Except for some minor concessions to small corporations, this bill proposes a 45-percent tax on all normal profits and a 90-percent tax on excess profits.

In judging whether or not that is desirable or economically sound, we must not lose sight of the fact that a corporation's income is earned for its stockholders. To the extent that it pays a tax on its income before distribution to stockholders, there is thus a tax duplication. Such duplication is reasonably tolerable when tax rates are low, but it becomes unbearable with extremely high rates. It is hardly necessary to demonstrate that under the proposed corporate rates, even for stockholders in the middle-income brackets, every dollar earned by a corporation would leave them only a few cents after they are through paying their own tax on the little that is left for dividend distribution.

If we were to grant that the profit motive is today unnecessary, there would still be needed an incentive for efficiency and economy in production. As the Secretary well pointed out, experience has shown that when taxes are too high they result in extravagance and waste in the conduct of business. With a 90-percent excess-profits tax rate, I am of the opinion that the combined normal and surtax rates for corporations should not exceed 33⅓ percent, except for capital-stock tax adjustments, which I shall comment upon in a moment. Also, I would rather see a 100-percent tax on excess profits, with a 25-percent post-war credit, than a 90-percent tax with a 10-percent post-war credit.

Senator VANDENBERG. Everything depends, does it not, on an accurate definition of what excess profits are?

Mr. SEIDMAN. That is correct. That is always a prerequisite.

In any event, once normal profits are arrived at, the full amount—not 95 percent of it, as is now the case—should be used as the yardstick for measuring excess profits. Why this yardstick should be tampered with and shrunk by 5 percent, after it has been carefully determined, the taxpayer never can understand, and he will continue to feel short-changed until this obvious injustice is corrected.

Many small businesses are today severely punished under our tax laws for having adopted the corporate form of doing business. These little companies are nothing more than partnerships, originally incorporated for such minor advantages as the corporate form of doing business affords. They did not then bargain for a steep income tax, plus a healthy surtax, plus a guessing-contest capital-stock tax, plus a burdensome excess-profits tax, plus substantial individual income taxes upon receipt of the remains of the corporate income. Small wonder that these little businesses would now like to be recognized as partnerships, which, in effect, they really are.

There is no reason, in justice or equity, why they should not be so treated for tax purposes. Each stockholder could then be required to pick up his pro rata share of the corporation income in his personal return, just as he would have to do in a partnership. Loss of revenue could easily be made up by rate adjustments. I respectfully urge that this change be made.

The bill still proposes to retain the capital-stock tax in spite of the Treasury's recommendation for its complete elimination. The Secretary had this to say on the subject when appearing before the Ways and Means Committee:

> The uncertainties of this period also make it important to reduce to the minimum the necessity for prophesying. The capital-stock tax and the associated declared value excess-profits tax are determined largely by the accuracy of guesses about futures profits. It is suggested that the revenue produced by these taxes can be more fairly and less harmfully produced by the other taxes on corporations and that accordingly the capital-stock tax and declared value excess-profits taxes be repealed.

It is difficult for taxpayers to understand why, in the face of such a recommendation, this thing should not be done. The Ways and Means Committee in its report accompanying this bill, recognizes some of the difficulties and tries to remedy them by providing for an annual declaration of value in lieu of the present 3-year requirement. That still leaves a substantial element to chance and coin-flipping. Certainly should be substituted for guesswork. The tax should be removed and loss of revenue made up by adjustment of the normal or surtax rate on corporate income.

Senator VANDENBERG. Do you have in mind the figure on that point that would be lost in revenue?

Mr. SEIDMAN. I do not believe it would make a difference of a fraction of 1 percent on income. The loss of revenue, I think, is $200,000,000.

The bill proposes a complete rearrangement in the treatment of capital gains and losses for individuals and corporations. The changes are in the right direction except for continuing to tax short-term gains at full normal and surtax rates and for limiting the deductibility of a net capital loss to $1,000 in any 1 year. I appreciate the difficulty of some of the problems here involved and the extent to which the drafters of this bill have gone to overcome them. I believe, however, that simplicity and considerably fairer results can be attained if no distinction were made between short- and long-term gains or losses. If, however, the distinction is to be made, then I suggest, both as to individuals and corporations, a tax limit of 15 percent for long-term gains and losses and 30 percent for short-term gains and losses.

This should prove desirable even from a revenue point of view. Experience has shown that the volume of capital transactions increases in inverse proportion to the tax rate; the higher the rate, the smaller the volume. That is readily understandable, for such transactions are nearly always within the control of the taxpayer, and since they frequently mean nothing more than his getting out of one investment and into another, they are avoided altogether if the tax cost is too high. As a result, the Government gets no revenue at all when it might get some if the rates were not so high. As an unfortunate byproduct, these high taxes act as an obstacle to the free movement of capital from industry to industry. In terms of our war effort, that means capital is being prevented from moving into industries where it is most needed or from being converted into cash for the purchase of War bonds.

The act proposes a basic change in the treatment of fiscal year taxpayers. The Ways and Means Committee, in its report, makes the point that so long as there is no great difference in tax rates between years, the present arrangement works out well but with drastic rate increases, hardships and competitive disadvantages result to calendar year taxpayers as compared with those on a fiscal year basis.

If this be true, then the converse is also true and competitive positions will be reversed when rates are adjusted downward as we hope some day they will be. Over a period of time, such advantages and disadvantages necessarily cancel out. There are, however, other important considerations involved. For nearly two decades, business associations and professional accountants' organizations have stressed the advantage of the natural business year in particular trades or businesses, for the taking of inventories, closing of books and preparing tax returns. Income is more clearly reflected in a natural fiscal year than in a calendar year. Among other things, seasonal pressure is avoided, inventories and receivables are then usually at their minimum, debts are correspondingly liquidated and accounts can be closed with the least number of adjustments.

Accounting firms have particularly appreciated this spreading out of their auditing and tax work over the year and have passed along to their clients the benefit of reduced costs over calendar year closings. Also, the work is done more carefully, with less pressure to meet the March 15 deadline for calendar year returns. Similar pressures have been eased for the Government as well, resulting in fewer extensions and more accurate returns.

If it is the purpose of the bill to tax all income earned in the same calendar year at uniform rates, then the bill is seriously defective in that it taxes 1941 income of fiscal year partnerships at 1942 rates to partners reporting on a calendar year basis. Thus, if a partnership is on a January 31 fiscal-year basis, the partners in their 1942 calendar year returns will be taxed as if their share of the partnership income were all earned in 1942, although in fact only one-twelfth of it was earned in 1942 and eleven-twelfths were earned in 1941 and should be taxable at the lower 1941 rates. Surely this change should not be made only in the case of corporations, where it happens to work out in favor of the revenue and not in the case of partnerships, where it works against the revenue. At least this correction in the bill should therefore be made, otherwise the effect will be to discriminate against the smaller businesses which are usually conducted in partnership form.

The entire proposal as to fiscal years harks back to the system last embodied in the 1932 Revenue Act. We had experience with the administration of this provision in that and prior revenue acts. Thtere were good and sufficient reasons for making the change to the present method. Those same reasons still apply. The preparation of a fiscal year return on a double tax-law basis is so thoroughly confusing and the arrangement carries with it so many undesirable features for the taxpayer that he is bound to want to return to a calendar-year basis of reporting. That would be a great pity after these many years of accomplishment in the field of fiscal-year accounting and income-tax reporting.

The bill proposes to treat losses from nonbusiness debts less favorably than those incurred in a trade or business. They would be con-

sidered as short-term capital losses and their deductibility limited to that extent. It is contended that nonbusiness bad debts are frequently the result of loans made to friends or relatives, and that repayment is not expected. Of course, where that is actually so, it has been the practice of the Treasury Department to disallow them as gifts and not debts at all. That practice can and should be continued. On the other hand, where the taxpayer has made a bona fide loan in good faith, the loss should be allowed as any other bad debt.

With the extreme tax rates under this bill, on profits that are likely to evaporate, one wonders what has happened to the announced purpose of permitting a reasonable reserve to be set up out of taxable income for possible inventory losses. One must remember in taxing a business, that it is the average income over a number of years rather than that of a single year that counts. The profit of a single year, even in normal times, does not represent the true earning power of a business. Yet, with tax rates reaching the confiscation point, a single year's profit is still the basis for tax. Should a loss year follow rather than precede a profit year—a phenomenon with which I fear we're going to have a lot of experience—then even the slight relief afforded by the limited net-loss carry-over provision is denied the taxpayer.

The net effect of this is to tax profitable years with little regard for loss years. That is indeed a one-sided arrangement even in normal times, but is particularly objectionable in times like these, when staggering losses may appear overnight, wiping out accumulated earnings, reserves, and even the capital of a business.

Good accounting practice and good business usage call for reasonable reserves to be set up out of current earnings to meet such risks. This is urgently necessary today in the valuation of inventories. For, with rising prices under war conditions, there is an element of inflation in inventories which should not be included in taxable income. A tax is now paid on this inflation, and there is no way in which the taxpayer can hope to recover it when the bubble bursts. The obviously equitable thing to do is to provide for the loss by a reserve taken out of the very profits which include the inflation. At present, such a reserve is not deductible from taxable income. It should be.

The present law gives a limited right for carrying forward net losses from one year to another. No provision, however, is made to carry losses back to profitable years. Such a provision is today sorely needed.

No one can say whether a company has really made any excess profits until this war is over. Much will depend upon what happens from here out and especially during the first 2 or 3 post-war years. All of the profits which corporations have been permitted to retain will usually be found in the form of inventory, plant, and other assets at inflated values. Substantial post-war losses may be expected in the liquidation of these assets. Such was the case after the last World War. Many companies who had paid huge excess-profits taxes found themselves in bankruptcy when the assets represented by these profits had finally to be liquidated.

To avoid a similar condition, it would seem appropriate to provide that profits made in any year beginning with 1940 shall be subject to adjustment because of losses in any of the 3 years following.

That is not too much for business to ask when it is required to pay a 90-percent tax on profits that may turn out to be nonexistent.

I respectfully urge you gentlemen to make that provision in this bill.

Senator VANDENBERG. Mr. Chairman, I want to comment on one figure on page 2 of Mr. Seidman's prepared statement, because I think it is very important.

Ever since the President and the Treasury made their widely publicized suggestion that incomes should be held to a ceiling of $25,000 my mail would indicate that there are thousands of people in the country who think that is all we need to do to pay for the war.

In fact, I received some resolutions this morning from very important labor organizations, passed on the theory that all you have to do is put this $25,000 income ceiling into effect, and that settles everything, you do not have to raise any more taxes. I want to emphasize Mr. Seidman's figure and I want to place it alongside Mr. Morgenthau's figure of how much we are spending a day. He says we are spending $150,000,000 a day on the war. You estimate that if we confiscate all of the $25,000 incomes and above in addition to the existing taxes, we would only get some $500,000,000.

Therefore, instead of paying for the war, we would just pay for 3½ days of the war. I just want to make that plain, because I think it is essential to straighten out public thinking on the subject.

Senator BARKLEY. Do you have the figures as to how many individuals this would apply to?

Mr. SEIDMAN. I estimate about 45,000, under 50,000. There are under 50,000 individuals in this country who have an income of more than $25,000 a year.

Senator BARKLEY. If you limited the income to $25,000 after the payment of taxes, of course, that would be a variable sum, depending upon the individual, so that the real net income would not be $25,000 but it would be a variable figure, depending on how much taxes the individual paid—State, county, city, and others.

Mr. SEIDMAN. That is correct, of course. For instance, a man living in North Dakota, in order for him to have $25,000 left, may have to receive a $100,000 income, because the State takes about $12,000 from the $100,000 and the Federal Government may take away about $65,000; that totals $77,000.

He would not have $25,000 if he makes $100,000 of income. There are only about 3,000 individuals in this country who have a $100,000 income.

Senator BARKLEY. Have you given any study, or do you know of anybody who has, to the relative merits of a proposal to exempt all taxes in arriving at a ceiling income of say, of $25,000, and the exemption of insurance premiums on the life of the taxpayer?

Of course, everybody who owns property pays taxes on it to support the Government, and, of course, to prevent it from being sold and to prevent dispossession; for the same reason, to protect one's family they insure their lives and pay out insurance premiums on it.

Have you given any thought to the relative merit of those two exemptions, taxes and insurance premiums, for instance?

Many people have no property, but in order to protect their families in case of death, they insure their lives, and that operates in the

same way, in the long run, as bequeathing property to a descendant upon which taxes are paid; this thing presents to me some analogous possibilities of treatment. I wonder if you have thought anything about it?

Mr. SEIDMAN. I have, sir.

In attempting to limit income to $25,000 you would, in justice, have to make some provision for obligations of that kind, but I would like to say in this regard that, in my opinion, this present bill that is now before you gentlemen in effect eliminates incomes over $25,000 completely. If you give effect to provisions for insurance and a reasonable provision for payment of debts that very bill before you confiscates everything above $25,000.

As you have seen, in the case of the $1,000,000 income, it may take everything; in the case of the $5,000,000, the taxpayer may owe the Government money for making the income.

Senator BARKLEY. You mean, over and above the income?

Mr. SEIDMAN. Yes, indeed, sir.

The CHAIRMAN. You mean when taking into consideration the State income tax.

Mr. SEIDMAN. Yes; but that is a deductible tax.

The CHAIRMAN. Yes.

Mr. SEIDMAN. He cannot retain that to pay his living expenses with.

The CHAIRMAN. You suggest setting up reserves here, Mr. Seidman, out of the profit of the current year You do not suggest any figure.

Have you given any thought to that point, as to what reserve it should be?

Mr. SEIDMAN. In connection with inventories I do not believe that you can arbitrarily set up any figure and say this shall be the measure of the reserve to be set up. Our revenue laws have had experience with reserves.

For instance, in the case of bad debts, the law permits a reasonable reserve to be taken out of the annual income for bad debts.

Now, the law can well be in as broad terms as that in connection with inventories.

The CHAIRMAN. I see.

Are there any other questions, gentlemen?

Senator BYRD. Mr. Seidman, I was not here when you read the first part of your paper. This estimate of $500,000,000 increase in Federal taxes on income above $25,000, the proposal, as I understand it, was that $25,000 be permitted to be allowed after the payment of taxes. When you stated that would bring in $500,000,000 did you take into consideration the taxes?

Mr. SEIDMAN. Yes, indeed; I am taking into consideration the taxes proposed by this bill, how much would be left to the taxpayer if the Government took the rest of it over $25,000.

Senator BYRD. Then you would get the $500,000,000 by taxing down to $25,000?

Mr. SEIDMAN. Yes, sir.

Senator BYRD. After they paid the present taxes?

Mr. SEIDMAN. That is right, sir.

Senator VANDENBERG. No; your figure means that if they took everything, you would only get $500,000,000?

Senator BARKLEY. You mean, of course, after allowing the man $25,000, after his taxes have all been paid. Those taxes are normal taxes that he has paid. You say then there would be still $500,000,000 more that would be gotten by limiting all incomes to $25,000?

Mr. SEIDMAN. That is correct. If this bill were to read that all incomes above $25,000 are hereby confiscated instead of what it now does read, the net result would be $500,000,000 more to the Treasury.

Senator BYRD. In other words, that is based exactly on the proposal that the President made.

Mr. SEIDMAN. Yes, sir.

Senator BYRD. In other words, that you could be allowed $25,000 above your taxes.

Mr. SEIDMAN. Yes, sir.

Senator BYRD. And this $500,000,000 would be all that would accrue from that taxation.

Mr. SEIDMAN. Yes, sir.

Senator BARKLEY. In case where a man had a million dollars' worth of property, he would be allowed to deduct taxes on all that property in arriving at the $25,000?

Mr. SEIDMAN. Yes, sir.

Senator BARKLEY. And it might absorb the difference between $25 000 and his actual income, might it not?

Mr. SEIDMAN. Yes.

Senator BARKLEY. In the case of a man who had no property, in the case of a man who made $30,000 a year, he would have to give up $5,000 of that; whereas, a man having a million dollars' worth of property, if the taxes absorbed all the tax between $25,000 and his actual income, he would not pay anything more.

Mr. SEIDMAN. That is correct.

Senator BYRD. Even then it would bring in only enough to pay the expenses of the Government for 3 days, approximately?

Mr. SEIDMAN. Yes, sir.

The CHAIRMAN. All right, Mr. Seidman. Thank you very much for your appearance.

(The following letter from Mr. Seidman was ordered printed in the record:)

SEIDMAN & SEIDMAN,
New York, N. Y., July 28, 1942.

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR: I intended to point out before completing my testimony yesterday that in the case of a taxpayer on an accrual basis it would not be possible for the combined effect of Federal and State taxes to be as my examples indicate. That is because to such a taxpayer the State tax is an income deduction in the same year and to that extent decreases the income subject to Federal tax.

As indicated, my examples involve a cash-basis taxpayer, and, of course, were chosen for emphasis. The taxpayer there, having a $5,000,000 income in 1942, would be called upon, under the proposed bill, to pay in 1943 a Federal income tax of $4 374,616 and a California tax of $740,950, or a total of $5,115 566. The $740,950 State tax so paid would, of course, be deductible from his 1943 income, subject to Federal income tax, if he has any such income in that year.

I would appreciate having this communication appear as a part of the record immediately following my statement.

Respectfully yours,

M. L. SEIDMAN.

The CHAIRMAN. Mr. Samuel Greenfield.
(No response.)
The CHAIRMAN. Mr. William Citron.

STATEMENT OF WILLIAM CITRON, REPRESENTING RIT PRODUCTS CORPORATION, CHICAGO, ILL.

The CHAIRMAN. Will you give your name to the reporter?
Mr. CITRON. William Citron.
The CHAIRMAN. What is your business, Mr. Citron?
Mr. CITRON. Manufacturer of household package dyes.
The CHAIRMAN. You are appearing for your own organization?
Mr. CITRON. That is right, and such other firms as may come under the same classification so far as this complaint that I have to register is concerned.
The CHAIRMAN. All right, sir. We will be very glad to hear you.
Mr. CITRON. In the first place, I would like to say in explanation at the beginning, that this taxpayer has no objection to the raising of taxes, realizing that there is a war on, that it will be necessary to pay for this war, and we have no objection to the rates. Our objection is that we have found ourselves in an inequitable position in regard to the manner of arrival at the normal tax.
The 4 years which we use as the basis for which normal taxes are now determined are the 4 worst years that this company has ever had in its existence.
There are no provisions in the present bill under which the taxes have been paid heretofore that give us any relief. The business that we are engaged in is not either helped or hindered by the war or the war operations.
Primarily, we manufacture a household dye. It is used for rehabilitation of clothing, men's, women's, and children's, as well as household fabrics. There has been a change in the general situation with regard to that. There have been quite a number of new fabrics come into the market, synthetics, acetates, that could not be dyed by the ordinary dye and the business required a new product. We had with us at the time an outstanding chemist, who has since died, in June of 1940. He was given the job of bringing out a new product that would take care of all of these new synthetics and instead of being able to do that in the 3 or 6 months that it would normally take, the man having been sick with hypertension, it took him about 4 years to complete that job.
May I give you some figures here that will clarify what I have in mind?
Senator BARKLEY. Are you speaking of excess-profits taxes?
Mr. CITRON. No; I am speaking of the basis on which we arrive at the normal taxes.
The CHAIRMAN. Arrive at the normal taxes?
Mr. CITRON. Yes, sir.
The CHAIRMAN. All right.
Mr. CITRON. We arrive at the normal taxes on the basis of the earnings during 1936 to 1939, both inclusive, those were the 4 worst years, that this company has ever experienced, for the reasons that I have assigned for that.
Prior to the 1936 period and subsequent to the 1939 period, the company was again on a normal-profit basis, that is, they made their

usual profits. We were more or less trapped behind those 4 years, not for any reasons we could help. It was just unfortunate that the doctor who was in charge of our chemical laboratory was sick, and subsequently died, and it took him 4 years to complete the job that he normally would have done in a few months.

What we are asking for under those conditions is to have a right to use any other 4 years during the depression period, or in lieu of that to have the right to use the intangible assets that we acquired at the time the company was taken over from a bankrupt concern, so that the normal taxes we would be paying on would be the normal taxes that we normally earned, that we had earned before this depression and subsequent to the depression; in other words, the average amount of earnings that we have had during a period of 12 years, from 1930 to date, or such other relief as the committee in its judgment, might dictate.

The CHAIRMAN. Are there any questions, gentlemen?

Senator TAFT. I do not quite understand what effect it has on the normal income. It has an effect on the excess-profits tax.

Mr. CITRON. That is the effect of the normal tax on the excess-profits tax, it brings the excess-profits tax to a higher level.

Senator TAFT. Yes.

The CHAIRMAN. That is undoubtedly true, but I made the same inquiry. On the normal you are only paying on what you actually earn, and if you raise at that point, it would simply mean a higher tax, unless you are also looking beyond that to your excess-profits tax.

You mean you haven't got a proper credit base against your excess-profits tax.

Mr. CITRON. That is right.

The CHAIRMAN. We understand that.

Senator TAFT. Have you studied the provisions of section 722, known as the relief provision?

Mr. CITRON. You mean the new bill coming out?

Senator TAFT. Yes.

Mr. CITRON. No.

Senator TAFT. It takes care of it.

Mr. CITRON. It takes care of it under certain categories. I believe I have got a copy of it in its initial form. It has subsequently been changed.

But all of the matters that are referred to in there, we do not come under that classification.

The CHAIRMAN. If you give careful study to section 722, I think you will find it will give you some relief. It may not give you full relief, but I think it undoubtedly will give you some relief in your case.

Senator TAFT. That is on page 209 of the bill.

Mr. CITRON. May I ask our accountant to come up a moment? He is pretty familiar with this bill.

Senator TAFT. I do not quite see why it is not covered by paragraph (2) on page 209 of the bill.

Senator CONNALLY. What he has in mind when he says "normal tax" is the normal tax in estimating the excess profits.

The CHAIRMAN. That is right.

Senator CONNALLY. Not the normal tax that everybody pays?

Mr. CITRON. No.

Senator CONNALLY. It is only the basis that you arrive at in determining the excess profits. You think you ought to have a larger percentage, because you did not make much during the 4 years, before we take 90 percent of the balance; is that what you mean?

Mr. CITRON. I feel Congress did not have in mind just getting a fellow behind a certain number of years, which are below the normal years, where everybody has had a more equitable arrangement.

The CHAIRMAN. That is true, but there are a great many relief provisions in the bill, in section 722 of the present bill, that undertakes to reach, in a large measure, your situation.

I think it does give you some relief. Of course, you have the general relief provision that you can take your invested-capital basis.

Mr. CITRON. That does not help us any. We took over a bankrupt concern, and in the process of taking it over we took over a great many intangibles, and we are not permitted to use these intangibles.

The CHAIRMAN. Did you say you had counsel here?

Mr. CITRON. Yes; I did.

The CHAIRMAN. He may come around just for a minute to show us just what your trouble is, but I think you are covered under section 722.

STATEMENT OF CARLETON M. TOWER, REPRESENTING RIT PRODUCTS CORPORATION, CHICAGO, ILL.

Mr. TOWER. My name is Carleton M. Tower.

The CHAIRMAN. Now, before you begin, when did you take over the bankrupt concern?

Mr. TOWER. As of January 1, 1927.

The CHAIRMAN. You took it over before the base period years?

Mr. TOWER. Yes, sir.

The CHAIRMAN. Have you studied section 722?

Mr. TOWER. Yes, sir. Section 722 does not give us relief, for the reason that the one point that would apply would be if the nature of the business has changed before or during the base period.

Now, it happens that the nature of the business changed immediately after the base period and the preliminary work for making the change was during the base period, so that section 722 does not afford this taxpayer any relief whatever.

Senator TAFT. The relief is in case—

the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer or because of the fact that industry of which such taxpayer was a member was depressed by reason of temporary economic events unusual in the case of such industry.

Mr. TOWER. That all depends upon the definition or the interpretation that is put on words. Now, if it is a temporary economic depression in this industry, it may be included there. The fact is this: This company has been making household dyes for a great many years, and until a few years ago the only fabrics to be dyed were the natural fabrics of wool, cotton, silk, and linen, and now all of a sudden science comes out with the acetates, with new fabrics, and they still use silk threads to put the new fabrics together.

Senator TAFT. Why is not that a temporary economic event in the history of the industry?

Mr. TOWER. It is a pure case of definition of words. It may or may not be. There is no certainty of it. I would like to suggest this to the committee, as a very simple and direct thing. I believe that what the Congress is after is a measuring stick to reasonably measure the ability of one taxpayer as compared to another to pay taxes. The Congress saw fit to elect as a base period a particular 4-year term. Now, it is perfectly true that a taxpayer who happened to have the best 4 years of his history is put in a very remarkably advantageous position, and it is equally true that a taxpayer who happened to have the only losses that ever occurred to the corporation during that base period is put in a most unfortunate position, and at best it is nothing but relying upon the interpretation of some words.

Senator CONNALLY. Would that not happen in any series of years?

Mr. TOWER. Well, sir, it may very well be; but it would create greater justice for a taxpayer to have a right, without appealing to any court or board, to elect to use as his base any 4 consecutive years during the depression period or, if you please, the whole of the depression period. I mean, if the purpose is to measure the ability to pay taxes, under this unfortunate circumstance, there should be a right, I believe, without an appeal to an administrative body.

The CHAIRMAN. Well, now, of course corporations have always had trouble with the excess-profits tax. A great many of them want to take 3 out of the 4 years. Nearly all corporations can point out that 1 of the 4 years in the base period was an unusually bad year. But you have got to have some base period, and you have got to have as nearly adequate relief provisions as you can devise. That is what Congress has been seeking to do, is to provide reasonable relief provisions. To allow taxpayers to select any group of years would, of course, obviously operate against the Treasury, because all of them would take the years in which they had the largest credit.

On page 210 of the bill, if you will look at it, it says:

> For the purposes of this subparagraph, the term "change in the character of the business" includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation—

and other things. So it does not all depend upon arbitrary discretion.

Mr. TOWER. I think the section you speak of is prefaced by another thing, it says that the change must have occurred during or immediately prior to, within 2 years prior to, the base period, and the fact is that the change in this taxpayer's business occurred a year after the base period.

The CHAIRMAN. I do not understand how the change did occur, because Mr. Citron here said he had abnormally low earnings during this base period because of this illness of a doctor.

Mr. TOWER. That is right.

The CHAIRMAN. On whom he mainly depended.

Mr. TOWER. That is perfectly true, but the profits arose from the introduction of a new product that this chemist devised.

The CHAIRMAN. I understand that. You had an abnormal condition in your business that seems to me is cared for in some respects. We get your point. You would like to have a longer period than the 4-year period.

Mr. TOWER. A specific right of the taxpayer to elect, without appealing to any governmental agency for interpretation, either any 4 consecutive years of the depression period or the entire whole of the depression period.

The CHAIRMAN. Yes. All right, thank you, sir.

Mr. Hyde.

STATEMENT OF WILLIAM TRUSLOW HYDE, JR., OF JOSEPHTHAL & CO., SCARSDALE, N. Y.

The CHAIRMAN. Will you give the reporter your full name and address?

Mr. HYDE. William Truslow Hyde, Jr., Scarsdale, N. Y.

The CHAIRMAN. All right, sir.

Mr. HYDE. Mr. Chairman, I do not have a copy of my statement, but I have a tabulation which I might want to refer to. I think it might be helpful if some of the members had a copy of it.

The CHAIRMAN. Very well.

(The tabulation referred to is as follows:)

[All figures in thousands]

Company	Preferred dividends	Net income, range 1936-39	Available for common stock based on 1941 earnings		
			Reported	(1)	(2)
Alabama Power [3]	$2,269	$1,407	$2,873	$251	$1,292
Cincinnati Gas & Electric [3]	2,000	1,951	1,020	335	1,235
Cleveland Electric Illuminating [3]	1,147	5,897	5,909	3,978	4,504
Consolidated Edison (N. Y.)	10,922	24,207	22,999	10,008	20,913
Consolidated Gas, Electric Light & Power (Baltimore)	1,279	5,205	5,102	3,697	4,254
Consumers Power [3]	3,425	5,670	5,920	2,486	4,028
Dallas Power & Light [3]	507	1,060	1,418	638	1,066
Dayton Power & Light [3]	450	2,260	1,972	1,190	1,395
Duquesne Light	1,375	8,615	8,035	6,771	7,390
Georgia Power	2,676	1,038	3,656	1,083	3,187
Gulf States Utilities	585	1,409	1,319	775	1,038
Idaho Power [3]	414	1,057	886	553	739
Jersey Central Power & Light	1,346	656	788	279	885
Kansas Gas & Electric [3]	521	729	525	238	472
Metropolitan Edison	1,265	2,160	1,955	1,206	1,776
Montana Power	958	2,209	2,558	1,485	1,916
Ohio Edison	1,867	2,331	2,032	926	1,767
Pacific Gas & Electric [3]	7,970	10,804	14,493	8,902	12,488
Public Service of Colorado [3]	670	2,621	2,311	1,403	1,795
Rochester Gas & Electric	1,393	1,232	888	465	1,094
Southern California Edison	6,004	7,268	7,689	4,783	7,061
Texas Power & Light [3]	865	1,291	840	302	692
Toledo Edison [3]	946	1,326	1,254	755	1,135
Virginia Electric & Power	1,172	2,295	2,659	1,599	2,126
West Penn Power [3]	1,337	4,856	4,415	2,818	3,473
Total	52,422	106,542	103,986	63,907	87,721

[1] Adjusted for House tax bill.
[2] Adjusted for tax rates in House bill and for deduction of preferred dividends from taxable income.
[3] Earnings subject to excess-profits tax.

The CHAIRMAN. You may proceed. Speak loud enough for the committee to hear what you have to say.

Mr. HYDE. My only purpose in appearing before your committee is to request that corporations be permitted to deduct preferred dividends from their taxable income. The higher rate of taxes which will apply to the 1942 earnings will make this necessary for public-utility companies to maintain their credit standings, to pro-

vide sufficient power for the armament industries, and to prevent their earnings from dropping sharply below normal levels.

Public-utility companies have a large investment in relation to their gross income, which means that their operating costs are low but their capital costs are high. To meet these conditions and to avoid possible financial difficulties during periods of low demand public utilities obtained some of their capital through the sale of preferred stocks. Preferred stocks are a hybrid security. Omission of dividends cannot precipitate receivership, but yet those dividends must be paid at a fixed rate before the common stockholders can receive any return on their investment, and I think that they should be treated as fixed charges for tax purposes.

To cite a specific example, the Public Service Corporation of New Jersey last year had an income, before taxes and before preferred dividends of $38,200,000. Under the rates of taxes in the House bill the company would be subject to a tax bill of $20,200,000, which will leave $18,000,000 available for dividends. It then must pay $11,500,000 in preferred dividends, leaving only $6,500,000 for the common stock.

Senator CONNALLY. Wait a minute now. The preferred dividend is on money that you borrow; is it not?

Mr. HYDE. If it were borrowed money the dividend would be deductible, but it is not borrowed money; it is a hybrid security, as I said. Preferred stock is not borrowed capital. You do not ever have to repay it. It is not a liability. Nobody can demand their money at a certain date, and omission of the dividend cannot put the company into receivership, but yet that dividend must be paid at a fixed rate just as though it were bond interest.

Senator CONNALLY. Somebody put the money; did he not?

Mr. HYDE. Yes.

Senator CONNALLY. You are paying him a dividend on it.

Mr. HYDE. Yes.

Senator GUFFEY. The company got the full benefit of all the money; did it not?

Mr. HYDE. The company got the full benefit of the money; yes.

Senator GUFFEY. When they borrowed it they contracted to put a certain rate on that money.

Mr. HYDE. Yes; but there is a distinction.

Senator GUFFEY. It is a cumulative preferred stock.

Mr. HYDE. Yes; it is not a bond. If it were bond interest, it would be deductible. That is my request, to allow the company to deduct their preferred dividends just as if it were bond interest.

The CHAIRMAN. You want the preferred dividend to stand on the same basis as interest on borrowed money.

Mr. HYDE. That is it exactly.

Senator BARKLEY. Of course, the interest on the bonds has to be paid before any common stockholder gets any money.

Mr. HYDE. Exactly.

Senator BARKLEY. And the dividends on the preferred stock have to be paid before the common stockholders get any money.

Mr. HYDE. Exactly.

Senator BARKLEY. So they enjoy a privilege that the common stockholders do not enjoy.

Mr. HYDE. Yes; and that is why they should be deductible.

Senator GUFFEY. That is, provided they are cumulative. Some preferred stock dividends are only paid from dividends earned. There are all kinds of preferred stock.

Mr. HYDE. Yes. If the dividend is paid it is paid at a fixed rate, regardless of the earnings.

Senator GUFFEY. That is right.

Senator BROWN. That fixed rate is generally quite a little higher than bond interest.

Mr. HYDE. Usually 1 to 2 percent higher, except in the case of recently refunded debt which carries a much lower interest rate. These earnings of $6,500,000 would compare with earnings of $14,500,000 during the years 1936 to 1939, which has been taken as the period of normal earnings.

The CHAIRMAN. Can you give us in percentage the holders of preferred stock that pays dividends held by people outside of the corporation or the utility as a general rule?

Mr. HYDE. I haven't any exact figure, but most of these utility preferred stocks were sold to small investors.

The CHAIRMAN. They were sold to people within the organization? They were not sold to common stockholders?

Mr. HYDE. No; they were mostly sold to raise outside capital.

The CHAIRMAN. You haven't any table showing the percentage in which they are held by outsiders?

Mr. HYDE. I am sorry; I do not. When I return I will get that figure and forward it to the committee.

The CHAIRMAN. I will be glad to get it.

Mr. HYDE. If the preferred dividends were permitted as a deduction, as they would be if they represented interest paid, the earnings of the company would be $11,600,000 on the basis of last year's earnings and on the basis of the rates approved by the House in this 1942 tax bill. That $11,600,000 is approximately what they earned last year for the common stock. It is a great deal better than what they will earn under the House bill, but it is still below what they earned in the base period.

This table shows many other companies. There are 25 of them that I have compiled, and in the total column I think it tells the story very clearly. The first column shows the preferred dividend requirements. The next column of figures is the average earnings over the base period. The next column is the earnings reported last year, then the column following that is adjusted for the House bill, the same earnings adjusted for the House bill. The final column would be the earnings adjusted for deduction of the preferred dividends. Now, in the total column the base period earnings average $106,000,000. Last year they declined to $104,000,000. Under the House bill, they would be only $64,000,000. This is all available for the common stock. Under my proposal, they would be close to $88,000,000. That, while not up to the normal earnings, is still somewhat better than what the House would permit these companies to earn.

An individual case—this is very interesting here—is the Consumers' Power. They earned $5,600,000 in the base period. Under the House bill they would earn $2,500,000. I would raise that up to $4,000,000. The individual companies are all quite similar to that, with the exception of the Georgia Power Co., which will earn more

this year. That merely reflects a saving of $2,000,000 through refunding all high-coupon bonds.

The present method of taxation, which does not recognize the fixed charge, which preferred dividends are, is also very unfair to these holders of the preferred stocks themselves, not the common but the preferred stocks. These stocks were sold as high-grade investments to individuals, usually in the territory served by the company. These individuals were willing to accept the fixed and limited rate of return for the added protection they received from the preferred stock, but now the Government is injecting itself ahead of these small investors and is removing their protection, which they acquired when they agreed to accept a limited return.

In the past the earnings of Cincinnati Gas & Electric have been sufficient to afford ample protection for the preferred dividend, and the preferred stock rarely sold below par. Today it is selling in the low seventies. I think that company is in this table. That company, on the basis of the House bill, would have only $300 000 as a protection for that preferred dividend. In other words, it would earn $2,300,000, and $2,000,000 of it would have to go out in preferred dividends. Normally, under the base period they would have $4,000,000 available for that $2,000,000 preferred dividend.

The Pennsylvania Power & Light Co., which is not listed is another company, and there are hundreds of others that would be similarly affected.

Senator TAFT. When they bought this preferred stock they knew the corporation net income taxes would always be ahead of the preferred stock dividend on whatever return they may receive. That is one difference between dividends on preferred stock and interest on bonds.

Mr. HYDE. That is true, but the tax at that time was 10 or 15 percent and not what it is today. Nobody objected to it, when the taxes were so low.

Senator BARKLEY. Of course, that might apply to taxation on real estate. The taxes might go up, and anybody who buys property knows they might go up. There is no difference in regard to preferred stocks as compared to any other property. There is no guaranty when they buy it that the tax rate will stay where it is.

Mr. HYDE. If these companies had sold bonds then the interest on those bonds would come ahead of the income taxes.

Senator BROWN. Yes; but they got a higher rate for their preferred stock.

Mr. HYDE. Not because of the tax.

Senator BROWN. That is one of the factors in it.

Mr. HYDE. Because the tax was so low at that time it did not make much difference.

Senator BROWN. Generally, the return on preferred stock dividends was higher than the return on corporate bonds. One of the reasons for it was because of the tax situation.

Mr. HYDE. A very minor reason. The principal reason is because preferred stock is junior to the bond. It is quite similar to the fact that a mortgage bond carries a lower rate of interest than a debenture bond because it has first claim on the earnings. Similarly, any preferred stock has a junior claim to any bond, and naturally must have the higher rate of return.

Senator TAFT. Mr. Hyde, I think the discrimination of this tax is so much greater against the common stockholder as compared to the preferred stockholder that there is no comparison at all. I do not think the preferred stockholder has anything to complain of. He is going to get his dividend. The common-stock holder on this same basis, where half of this preferred stock is not going to get dividends, the common stockholder is not going to get any dividends at all, although it represents money that he put in.

Mr. HYDE. That is quite right.

Senator TAFT. I cannot see any reason to say that the preferred stockholder is discriminated against. It seems to me the discrimination is against the common stockholder and not the preferred stockholder.

Mr. HYDE. Naturally, the earnings left over for the common stockholder are affected.

The CHAIRMAN. That, I think, is the point Mr. Hyde is making, that is, he wants this dividend treated as an interest payment.

Senator BROWN. For the benefit of the common stockholder.

Mr. HYDE. Yes; for the benefit of the common stockholder, and also for the benefit of the preferred, although, as Senator Taft says, it is not as pressing in their case as it is in the case of the common stockholder.

The CHAIRMAN. We get your point. Is there anything else?

Mr. HYDE. I just wanted to mention the cost of it to the Treasury. That, of course, in these times, is a very important factor. I, unfortunately, have no figure on the total preferred dividends paid, but according to the Edison Electric Institute, last year utility companies paid $132,000,000 in preferred dividends. Utilities are the primary, shall I say, users of preferred stock, because it is so adaptable to their business. I doubt whether the total preferred dividends would amount to more than $150,000,000.

Senator TAFT. Every corporation formed after this time would have two-thirds of its capital in preferred stocks.

Mr. HYDE. I think it must be definitely limited to preferred stocks outstanding, not to extend it in the future. As a matter of fact, as to public utilities the S. E. C. would not allow them to.

Senator TAFT. You haven't got many preferred stocks in other companies.

Mr. HYDE. No. On the basis of 45 percent as the tax rate the $150,000,000 exemption would mean only about $70,000,000 to the Treasury, which is a cheap price to pay for the maintaining of the credit of utility companies, which includes the ability to raise equity capital and to protect the dividends. There are 3,000,000 holders of utility stocks, and it would help to protect their dividends during the period of increased living costs.

Senator BROWN. This bill will greatly interfere with the financing of preferred stocks in the future?

Mr. HYDE. Most specifically. It will be practically impossible. As a matter of fact, the Virginia Public Service recently abandoned an original plan of refinancing, which was approved, or I might say met the requirements of the S. E. C., and included the preferred stock. It superseded that with a plan which did not include any preferred stock but instead had debenture bonds, and that was approved by the

S. E. C. with reservations, yet it was just a stopgap until a better plan could be arranged.

The CHAIRMAN. Any additional questions, gentlemen?

Thank you very much, sir.

Mr. HYDE. Thank you.

The CHAIRMAN. Mr. Eagle.

STATEMENT OF J. FREDERICK EAGLE, OF PATTERSON, EAGLE, GREENOUGH, AND DAY, NEW YORK, N. Y., REPRESENTING TENANT-OWNED APARTMENT ASSOCIATION

The CHAIRMAN. Mr. Eagle, give the reporter your name.

Mr. EAGLE. J. Frederick Eagle, on behalf of Tenant-Owned Apartment Association, New York, N. Y.

I am advocating an amendment to the Internal Revenue Code so as to permit a cooperative apartment owner to deduct from his net income, in determining his Federal income tax, the taxes and interest which he is required to pay as part of the maintenance of the cooperative enterprise. I am advocating this because I think it is eminently fair, and, on the other hand, I am convinced that if the legislation is enacted it will inure to the benefit not only of the public but to the benefit of the Treasury of the United States. My memorandum is printed in part and typewritten in part, and I think probably it would be better if I stick pretty closely to the printed part and will not go into the balance.

The so-called cooperative apartment corporation is one organized not for profit but for the purpose of holding title to an apartment house and providing and leasing apartments therein as permanent homes to its stockholders.

Senator VANDENBERG. How extensive is that practice?

Mr. EAGLE. Well, in New York the investment in 1941 I think was about $350,000,000, and throughout the United States I am told it is vastly in excess of half a billion dollars.

It allocates its entire capital stock to such apartments according to their size and desirability, and as landlord leases them under what are termed "proprietary leases." Every stockholder must be a proprietary lessee and every proprietary lessee of an apartment must own the number of shares of the corporation's capital stock which has been allocated to it.

Each proprietary lessee agrees to pay as rental for his apartment his pro rata share, based on stock ownership, of the maintenance charges of the cooperative enterprise, including taxes, interest, and general and overhead expenses.

The cooperative apartment house in its inception was planned as an economic venture whereby several people, desiring to curtail expenses, might acquire and maintain permanent homes in a multiple dwelling building and use a corporation for the purpose of holding title to and managing the property, but without compensation.

The term "cooperative apartment owner" is a misnomer but is generally used in referring to the proprietary lessee, that is, the stockholder-tenant.

Cooperative apartment houses as a class have been failures, as a result of which:

1. The proprietary lessees and stockholders have lost or are losing their entire investments.

2. Mortgagees have lost and are losing taxable incomes.

3. The value of all apartments and residential property has been impaired.

4. Real-estate assessments have necessarily been reduced.

5. Writs of certiorari to review assessments are constantly being prosecuted, resulting in large tax refunds.

6. Federal and State income, inheritance, and estate taxes are adversely affected.

The plight of the cooperative apartment houses, and incidentally, the plight of the holders of mortgages thereon, is attributable largely, if not solely, to the fact that a person who acquires a cooperative apartment for his home is not entitled to deduct from his net income in determining his Federal income tax, the taxes and interest which he is required to pay as part of the maintenance of his cooperative apartment.

I might say in connection with the cooperative apartment that the taxes and interest constitute about two-thirds of the maintenance of the apartment. Therefore, if a person paid $3,000 rent for a cooperative apartment, $2,000 of that would be paid on account of taxes and interest.

A person who owns a house as his home may make such deductions, and if several people hold real property jointly or in common, they are likewise permitted to make such deductions, and there is every equitable reason why a person who owns a cooperative apartment as his home should have the same right.

When President Roosevelt was Governor of the State of New York, the New York Legislature enacted subdivision 13, now subdivision 12, of section 360 of the tax law (chapter 412, section 1 of the Laws of 1931), which reads as follows:

In the case of any taxpayer who is the owner of shares of stock in a corporation organized and existing exclusively for the purpose of owning and operating a cooperative multiple dwelling no part of the net earnings of which inures or is calculated or intended to inure to the benefit of any stockholder or individual, and all the expenses of which are paid annually by the stockholders in proportion to their ownership, a deduction shall be allowed to such taxpayer as to the share of his payments for all taxes, other than franchise taxes, paid or accrued by such corporation during the taxable year, and all interest paid or accrued by such corporation during the taxable year on its indebtedness.

Anent that legislation the New York Herald Tribune of January 29, 1931, contained the following article:

TWO TAX MEASURES HELP PARTNERS IN APARTMENTS

BILLS AIMED TO PERMIT DEDUCTION OF MAINTENANCE CHARGES FROM INCOMES

(By a staff correspondent)

ALBANY, January 28.—Legalization of the existing practice of the State department of taxation and finance in permitting owners of cooperative apartments to deduct on their personal income tax returns the portion of annual maintenance charges spent for water taxes, real-estate taxes and interest is the aim of measures introduced in the legislature today by Senator Samuel H. Hofstadter and Assemblyman Abbot Low Moffat, New York Republicans.

"A man who owns his own home is permitted to deduct the taxes which he pays on it and the interest which he pays on his mortgage when computing his income tax," Mr. Moffat said today.

"There is no reason whatsoever why people who jointly own the building in which they live and create a non-profit-making corporation for the purpose of holding title and operating a building should not equally be entitled to deduct their share of the taxes on the building and their share of the interest paid on the mortgage.

"The fairness of this position has long been recognized by the department of taxation and such deductions are permitted at present."

Eminent counsel were of the opinion that such enactment merely clarified the true, logical, and equitable intent of the New York tax law as previously enacted and as previously construed by the State tax commission, and were also of the opinion that the United States income tax laws should be similarly construed. A cooperative apartment corporation is not run for profit and, insofar as taxes and interest are concerned, merely acts as intermediary in behalf of those beneficially interested, that is, the cooperative apartment owners.

If Congress should enact a similar law, it is submitted that an immediate demand for cooperative apartments would be created, the taxable values of all property would be increased, mortgages would be better secured and the possibility of adding to the large quantities of "frozen real estate" would be greatly lessened.

Assuming that the theory of the cooperative apartment is economically sound—and naturally it costs less to maintain a multiple dwelling than to maintain a number of separate homes of equal character—it should be encouraged and the participants therein should not be penalized as they now are.

It is well recognized that home owners in any——

Senator BROWN. Mr. Eagle, might I interrupt?

Mr. EAGLE. Yes.

Senator BROWN. I am impressed with the fairness of your proposition, but it seems to me there is a failure to distinguish between the taxes and interest and the general and overhead expenses. I grant you should be, it seems to me, entitled to deduct interest on the mortgage and taxes, but not general and overhead expenses to maintain that building.

Mr. EAGLE. No, no; you should not; of course not.

Senator BROWN. You are talking about it in your second and third paragraphs. You include general and overhead expenses. They ought not be deducted.

Mr. EAGLE. If that is the way you read it, it was not the way I intended it.

Senator BROWN. You are clear on the point that what you are asking for here is a deduction of the interest on the mortgage and the taxes?

Mr. EAGLE. That is all.

Senator BROWN. Nothing more?

Mr. EAGLE. That is all.

Senator CLARK. In other words, you are asking to have an owner of an undivided share in one of these cooperative apartments put in exactly the same position as if he bought a house and had a mortgage on it?

Mr. EAGLE. That is exactly it.

Senator BROWN. Not to maintain it?

Mr. EAGLE. No; not at all. I am sorry if it is confused.

Senator TAFT. Mr. Eagle, there are some cooperative villages now authorized by the Housing Authority. Do you know what the law is that applies to them?

Mr. EAGLE. I do not; no.

Senator TAFT. There are several in Cincinnati.

Senator RADCLIFFE. Mr. Eagle, the interest which any one man would have in the cooperative apartment would be restricted to what might be termed the proportionate value of the property?

Mr. EAGLE. That is right.

Senator RADCLIFFE. I can readily see where otherwise you might be getting the benefit of an investment which really did not apply on owned houses. In other words, if there were 10 apartments there, his interest might be one-fourth or one-fifth of the total. You would restrict it to what would represent the actual value of his property?

Mr. EAGLE. Absolutely. That is the way the New York statute is. My suggestion is that you adopt the wording of the New York statute. I have the New York statute right in my memorandum.

It is well recognized that home owners in any community have a stabilizing effect, not only on the community but also upon the values of real estate therein. The Federal Government, as evidenced by its H. O. L. C. and F. H. A., recognizes the importance of home owners but the Federal tax law—probably through inadvertence but nevertheless as administered—penalizes the owner of a cooperative apartment if he lives in it. Furthermore, cooperative apartment owners are abandoning their investments for the reason that under the existing conditions the inequitable tax burden more than offsets the economy of a cooperatively owned multiple dwelling.

It might be contended that the amendment now advocated would adversely affect Federal income taxes but it is submitted that that is not true. If a cooperative apartment owner sublets his apartment and it thereby becomes a business venture, he becomes entitled to deduct not only his pro rata share of interest and taxes but also his share of all other maintenance charges, and the vast majority of cooperative owners have been driven to that expedient. Furthermore, the plight of the cooperative apartments has had, and is having devastating effects on mortgages and real-estate values which adversely affect income-tax collections. A demand for cooperative apartments would tend to lessen the depression in respect of real-estate values, which in itself would create taxable income. Enormous losses—income-tax deductions—which are constantly being taken as a result, directly and indirectly, of foreclosures, would be decreased. Mortgages on cooperative apartment houses would be better secured and mortgagees would receive greater taxable income. These changed conditions would necessarily inure to the benefit of the entire community and create additional taxable income.

Of course, the amendment would result in increased Federal and State inheritance and estate taxes as the proprietary lease with accompanying stock would then have a taxable value which is not a fact at the present time.

The inequitable burden placed upon cooperative apartment owners is without compensating tax revenue, hence, and in the public interest, it is submitted that Congress should enact a law amending section 23 of the Internal Revenue Code by adding thereto a new subdivision after subdivision (c) thereof, to read as follows:

In the case of any taxpayer who is the owner of shares of stock in a corporation organized and existing primarily for the purpose of owning and operating a cooperative multiple dwelling no part of the net earnings of which inures

or is calculated or intended to inure to the benefit of any stockholder or individual, and all the expenses of which—less an amount equal to rentals received by it from tenants other than stockholders—are paid annually by the stockholders in proportion to their ownership, a deduction shall be allowed to such taxpayer as to the share of his payments for all taxes, paid or accrued by such corporation during the taxable year, and all interest paid or accrued by such corporation during the taxable year on its indebtedness.

The above is the same as the New York law, with the following exceptions:

1. In the second line, the word "primarily" is substitued for the word "exclusively." The reason for this is that many cooperative apartment houses have doctors' offices or stores on the ground floor which are not necessarily cooperatively owned.

2. In the fifth line, the parenthetical clause "(less an amount equal to rentals received by and from tenants other than stockholders)" has been inserted. This would cover a situation where there are doctors' offices, and so forth, on the ground floor or where some of the cooperative owners may have become insolvent, resulting in the cooperative apartment corporation reacquiring the stock and lease of the insolvent proprietary lessee.

3. The words "other than franchise taxes" have been omitted, for the reason that those words refer to New York franchise taxes, and under the Federal statutes all taxes are deductible.

I believe the New York statute has been construed by its taxing authorities as though the above suggested changes 1 and 2 were, in fact, embodied therein.

Attached to my memorandum is a supplemental memorandum and a copy of my letter of May 7, 1942, to Hon. William T. Pheiffer, M. C., each of which was submitted to Randolph E. Paul, Esq., Assistant to the Secretary of the Treasury; Mr. Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation; and Mr. Timothy C. Mooney, Deputy Commissioner, Bureau of Internal Revenue, on June 9, 1942, at a conference held in Congressman Pheiffer's office.

The letter among other things refers to the supplemental memorandum and the fact that a proposal similar to that now advanced had been considered in 1928, included by the Committee on Ways and Means in its bill but deleted by the Senate Finance Committee. The reasons for deletion and the fallacies thereof as I see them are stated in the letter.

It seems to me that the adoption of the proposed legislation would be a gesture which would help thousands of people to use an economic method of maintaining a home, would be in the public interest, and would cost the Federal Government nothing.

The CHAIRMAN. Mr. Eagle, I believe there was some effort some years ago, was there not, to deal with this?

Mr. EAGLE. There was in 1928.

The CHAIRMAN. There was a provision in the House bill that undertook to cover your situation?

Mr. EAGLE. That is correct.

The CHAIRMAN. Now, did you present this problem to the Ways and Means Committee?

Mr. EAGLE. Not to the committee, but through Chairman Doughton I had the opportunity to present it to Mr. Stam and to Mr. Paul, and we had a conference on it. I was received so courteously that

I think it was sympathetically. Whether I am wrong or not I do not know.

The CHAIRMAN. You misinterpreted the courtesy for relief.

Mr. EAGLE. That may be. I may have misinterpreted sympathy for sympathetic. Maybe they thought I was a poor boob.

Senator RADCLIFFE. Do you think the language you just read clearly precludes the owner shares of stock from getting the benefit for shares which represent a greater amount than the value of the shares for his particular apartment in the apartment house?

Mr. EAGLE. It is not conceivable under the New York statute, and it is not conceivable under the legislation I propose.

Senator RADCLIFFE. It says one who holds shares should have a credit for those shares. Those shares may represent more than the value of his part of the apartment. I have no doubt that may be covered somewhere else, but I do not think that language there makes it clear.

Mr. EAGLE. The language of the act, you mean?

Senator RADCLIFFE. The language of your proposal. He may own shares, but they may be more than his proportion, looking at it from the standpoint of his home.

Mr. EAGLE. In the cooperative apartment house, the stock is so allotted as to cover each apartment. Suppose there are 10 apartments in the house, if they are all exactly of the same value each one gets one-tenth of the stock, but if 1 was a very poor apartment he might only get one one-hundredth part of the stock. Any person who had one one-hundredth part of the stock would only get the benefit of one one-hundredth part of the tax and interest which is paid by the cooperative apartment.

Senator RADCLIFFE. What would the man get if he had one-fifth share? Is not he getting more than his share?

Mr. EAGLE. No.

Senator RADCLIFFE. His home is only one-tenth; now, why should he get more than the one-tenth?

Mr. EAGLE. If his home is only one-tenth, he gets one-tenth.

Senator TAFT. The stock is tied up with the home. He cannot get more?

Mr. EAGLE. No, he cannot.

Senator RADCLIFFE. He said a poor man might own one one-hundredth instead of one-tenth. Who owns the remaining part to correspond to his one-tenth?

Mr. EAGLE. There may be 99 tenants in the apartment, and he has one-tenth of the entire cooperative enterprise; he has a little apartment for which he has bought a very small amount of stock. The other people have bought the remaining stock and the remaining interest in the cooperative enterprise.

Senator RADCLIFFE. Would not that mean in that case that someone would get more credit than he would if he were simply paying taxes on what he really owned?

Mr. EAGLE. No, sir.

Senator HERRING. The one with the larger interest would see that he got what he was entitled to.

Senator BARKLEY. He would get credit in the proportion that his apartment bears to the whole.

Mr. EAGLE. Yes.

Senator BARKLEY. They are different-size apartments.

Mr. EAGLE. They are different size and in different localities. Some have the south, some the east, and so forth. They are better or worse.

Senator BARKLEY. The price is fixed on the value of the apartment?

Mr. EAGLE. The price is fixed upon the value of the apartment, the value which a real-estate appraiser would put upon the apartment.

Senator BARKLEY. It could not be the same in each case.

Mr. EAGLE. It could not be the same in each case.

Senator BARKLEY. Each one does bear a relationship to the whole.

Mr. EAGLE. That is right.

Senator BARKLEY. One man might own an apartment that would be about one-tenth of the enterprise, while another one might own a small one, a back corner one, that would not be more than one-thirtieth of the total?

Mr. EAGLE. That is correct.

Senator CONNALLY. Is it your contention that if a man owned an apartment and subrented it, that he would be entitled to a deduction?

Mr. EAGLE. Under the present law, as I understand it, if a person owns a cooperative apartment and subrents it, it then becomes a business enterprise and he is then entitled to deduct his entire maintenance from the income.

The CHAIRMAN. He can deduct both the interest and the overhead?

Mr. EAGLE. All the overhead.

The CHAIRMAN. The Treasury has ruled undoubtedly that the owner of an apartment in one of these enterprises cannot deduct the taxes paid or the interest paid as a deduction from his personal income.

Mr. EAGLE. They have always held that, and then it went up to the Circuit Court of Appeals, Second Circuit, and they held that the literal interpretation of the statute as enacted would not permit it. They said if Congress wanted to grant this relief they ought to enact a law. That is why we are here.

Senator CONNALLY. In case he sublet he would treat his rent as income?

Mr. EAGLE. Exactly.

Senator RADCLIFFE. The amount of stock would correspond exactly with the interest in the apartment?

Mr. EAGLE. That is right.

Senator RADCLIFFE. The ownership of stock by him could not either be increased or decreased?

Mr. EAGLE. Not at all; no.

Senator CLARK. In the case of a small fellow who has a less desirable apartment, his part of it in the interest and taxes would be less than that of the man who owned a more desirable apartment, just the same as the owner of a small house pays less tax and interest than the owner of a big house?

Mr. EAGLE. Exactly.

Senator VANDENBERG. Like renting a room in a hotel; you might get a $2 hall bedroom or you might get a $12 bridal suite.

Mr. EAGLE. Quite right.

The CHAIRMAN. Mr. Eagle, thank you, sir, for your remarks.

(The supplemental memorandum and letter submitted by Mr. Eagle are as follows:

SUPPLEMENTAL MEMORANDUM, SUBMITTED BY J. FREDERICK EAGLE, NEW YORK, N. Y., RE PROPOSED AMENDMENT TO INTERNAL REVENUE CODE TO PERMIT COOPERATIVE APARTMENT OWNER TO DEDUCT FROM HIS INCOME THE PROPORTIONATE SHARE OF TAXES AND INTEREST PAID BY HIM AS PART OF THE MAINTENANCE OF THE COOPERATIVE ENTERPRISE

In the city of New York and elsewhere there are innumerable unoccupied, unproductive, and unsalable residential properties owned by people of large means. The owners thereof deduct from their incomes, in determining their Federal income taxes, the real-estate taxes paid on such unproductive properties, as well as interest paid on any mortgages thereon. Of course, the deductions come from the top brackets, and, if the owners are of large means, the resulting loss to the income-tax collectors is large.

Naturally, if a plan could be devised under which a demand could be created for such unoccupied residences by people of small means, there would be a net gain to the tax collectors, as the deductions would come from lower income-tax brackets. The proposed legislation would create such demand.

The present-day cooperative apartment house, which is rapidly vanishing, is an outcome of an earlier economic practice of friends combining their resources to acquire homes by purchasing a house for their joint use and having the title held by a corporation so as to avoid title complications in the event of death. The resulting economies, such as one kitchen, one furnace, less service, and no middleman's profit, were appealing and would be appealing to home lovers of moderate means, and, were it not for the present tax law, such persons would create a demand for the now unoccupied and unproductive residential properties. Of course, only people of moderate means would resort to that practice, but, if they purchased properties from people of large means, the advantage to the income-tax collector is apparent.

Assume that a person has taxable income of, say, $16,000. Under the present tax law he pays 4 percent normal tax and 20 percent surtax in excess of $12,000. That leaves him about $13,000 unless, of course, he has to pay a State income tax as well. If he and a friend buy a house which is assessed at $30,000 and place a 5 percent $20,000 mortgage thereon, the taxes and interest would amount to approximately $1,000. If, as tenant in common, he owned one-half the house, he would be entitled to deduct $950 from his income in determining his income tax, which would reduce his income tax by about $314. If, on the other hand, the title were held by a corporation, i. e., a cooperative apartment corporation, under the present tax law he would be penalized to the extent of $314, which would, of course, offset all preconceived economies.

Large apartments, i. e., over 10 rooms, are a drug on the market, and the situation has been aggravated by the owners of cooperative apartments being unwilling or unable to occupy them, due to the tax discrimination. Rents are thereby reduced, and high-class buildings—built for, say, 12 apartments—are being converted into glorified tenements to contain 4 or 5 times that number of apartments. Where this practice obtains to any great extent, the character of the neighborhood is changed, and the assessable values of the properties are decreased. A casual observer can notice that ever-increasing trend in the Park Avenue and Fifth Avenue sections in New York City. We all love babies, baby carriages, bicycles, and kiddy cars if they are our own, but too many of them crowded into one building do not add to the value thereof.

It would be a godsend to the city of New York if the character of the large apartments and the neighborhood wherein they are located could be maintained, and that result could be accomplished by the proposed legislation inasmuch as cooperative apartments of considerable size could be occupied and economically maintained by the owners thereof, if they were not discriminated against under the tax law.

PATTERSON, EAGLE, GREENOUGH & DAY,
New York, N. Y., May 7, 1942.

HON. WILLIAM J. PHEIFFER, M. C.,
House of Representatives, Washington, D. C.

DEAR MR. PHEIFFER: I have your letter of May 5, 1942, and am very glad to note your interest in the proposed amendment to the Internal Revenue Code whereby a cooperative apartment owner would be entitled to deduct from his income, in determining his income tax, his proportionate share of the taxes and interest paid by him as part of the maintenance of the cooperative enterprise.

I have asked the Tenant-Owners Apartment Association, Inc., of 660 Madison Avenue, New York City, to obtain the information which you desire and have been assured that it will be forthcoming early next week.

Many of the real estate firms in New York are interested in the subject and I believe that practically any of them would be glad to give such information as was available. I have in mind Pease & Elliman, Inc., 660 Madison Avenue; Douglas L. Elliman & Co., Inc., 15 East Forty-ninth Street; Brown, Wheelock, Harris, Stevens, Inc., 14 East Forty-seventh Street; and Douglas Gibbons & Co., Inc., 73 East Fifty-seventh Street.

Some days ago a publicity man from the office of Pease & Elliman, Inc., talked with me in the hope that he could get the New York newspapers to advocate the legislation. For his guidance I gave him an additional memorandum, of which the within is a substantial copy.

I note that Mr. Randolph E. Paul, in his letter to you, of which you forwarded me a copy, says that a proposal similar to that now advanced received consideration in the Revenue Act of 1928. In that connection, we should consider the conditions which then prevailed. Rents were abnormally high and a cooperative apartment seemed to offer a haven for which there was a great demand. The tax discrimination was then of little consequence as compared with the excessive rent of a similar apartment in a commercial apartment house. Now, that income taxes are of real moment, the tax discrimination cannot and will not be borne—that is to say, it is more economical for the cooperative apartment owner to abandon his investment and rent in a commercial apartment house—a practice which has become prevalent.

Mr. Paul, in assigning the reasons for the Senate deleting the provision in the 1928 Revenue Act, says:

(1) "It was believed that such a deduction would be practically impossible to administer and would afford an easy means of tax evasion in many cases";

(2) "It was also pointed out that no comparable deduction was given to the great number of individuals who leased apartments by the year;" and

(3) "The purchaser of a cooperative apartment is permitted to deduct the interest on the unpaid portion of the purchase price of an apartment."

As to (1), the belief has proved to be inaccurate. The New York income-tax law, since 1931, permitted a similar deduction. Insofar as I know, the administration thereof has been simple and has not afforded an easy means of tax evasion. Each cooperative apartment corporation files an income-tax return and each one allocates to each proprietary lessee therein his proportionate share of the taxes and interest payments. Every taxpayer, in claiming such deduction, must show in his return the particulars thereof and every such deduction can be readily checked.

As to (2), it should be borne in mind that the proprietary lessee has an investment whereas the ordinary tenant has no investment. Furthermore, a prospective tenant, if he rents an apartment in a commercial building, must pay the rental demanded by the landlord, but the landlord, if he runs a commercial apartment house, is running it for profit. He deducts from his income, in determining his income tax, the amount which he pays out as taxes and mortgage interest, and naturally the amount that he can deduct from his income is a principal factor in determining the amount which he must demand for rental. The greater deduction which the landlord can make, the less he is required to demand from the tenant, and the tenant does thereby get the benefit of the deduction.

As to (3), possibly I do not understand the third objection. There is no objection to the purchaser of a house deducting the interest on a purchase money mortgage, and if that is correct, why should not the purchaser of a cooperative apartment be entitled to deduct the interest on a purchase-money mortgage; i. e., the unpaid portion of the purchase price of an apartment.

I am confident that a careful study of the situation will clearly demonstrate that the stated reasons for deleting the provision from the Revenue Act of 1928 will show that they are without merit, particularly in view of present conditions.

As you doubtless know, the right of a cooperative apartment owner to make the deductions under the present law has been litigated. *Wood* v. *Rasquin, Collector of Internal Revenue* (21 Fed. Supp. 201), affirmed without opinion by Circuit Court of Appeals, Second Circuit (97 Fed. Rep. 2d, 1023), is the principal case. This was decided against the taxpayer on the theory that the tenant was not obligated to pay the tax and that the tax had, in fact, been paid by the corporation and had been claimed by it as a deduction in its income-tax return. The reasons are literally sound, but the Court intimated that if Congress wished to remedy the situation it could do so by legislation.

I call to your attention also *Boland* v. *Commissioner of Internal Revenue* (123 Fed. 2d. 358).

In considering these cases it should be borne in mind that the person who really pays the tax is the cooperative apartment owner and that funds for such payments are merely siphoned through the corporation. In this siphoning process the corporation receives and pays out exactly the same amount for interest and taxes, but the apartment owner, who is the real payer of the taxes and interest, receives no income-tax benefit therefrom.

Perhaps it would be helpful if I explained my position in the matter. Although I have appeared as attorney for the Tenant-Owners Apartment Association, Inc., I expect no compensation from it or from anyone else for my services.

I was president of a cooperative apartment for about 10 years, and during that period represented five or six other cooperative-apartment corporations. Furthermore, I owned a cooperative apartment and still own one, although I have initiated proceedings whereby I will be able to abandon it. From my experience I became convinced that the tax discrimination against cooperative owners was the primary cause of their troubles and that it was, in fact, harmful to all real estate. After I had given the matter considerable thought I determined to urge the legislation in the public interest. I doubt very much if the legislation would be helpful to me, individually, although if it were enacted promptly I might determine to hold my apartment.

If you wish any further information on the matter which I can furnish, please do not hesitate to call upon me.

Yours very truly,

(Signed) J. F. EAGLE.

The CHAIRMAN. Mr. Henry Forster.

STATEMENT OF HENRY FORSTER, OF BROWN, WHEELOCK, HARRIS, STEVENS, INC., NEW YORK, N. Y.

The CHAIRMAN. Will you give your name and address?

Mr. FORSTER. Henry Forster, Garrison, N. Y.

The CHAIRMAN. You represent Pease & Elliman, Inc.?

Mr. FORSTER. No, sir; that is a typographical error. It should be Brown, Wheelock, Harris, Stevens, Inc.

The CHAIRMAN. You want to be heard on the same question?

Mr. FORSTER. Yes, sir. I have just a few remarks to make.

The CHAIRMAN. We will be glad to hear you.

Mr. FORSTER. I have no prepared or formal statement.

I wish to second what Mr. Eagle has so clearly stated. Possibly he did not emphasize enough the benefit to the Federal Government that would accrue if the proposed deductions are permitted. The real-estate market would certainly be stimulated. This would mean increased commissions to brokers, which would be taxable; also profits to recent buyers of properties which would also be taxable income. With the increased activity and increased real-estate values all sorts of benefits would accrue and many losses now facing owners or mortgagees would not occur. Many of the mortgages are split up in the form of bonds and certificates held by the public. Increased business and reduced losses always mean increased taxes, and the Government is the gainer.

For more than 30 years I have been in the real-estate business, specializing in residential properties in the Borough of Manhattan, New York City. For two-thirds of that time I have been very actively engaged in all phases of cooperative apartment work, selling the land, arranging for the construction of the building, pricing and selling the apartments, managing the completed buildings, working out their financing, and so on.

For the last 10 years there has, of course, been very little selling of such apartments, due in great measure to a decline in rents and the extra burden thrown on the individual owners by reason of their not being allowed interest and tax deductions. The home owners of the Nation are admittedly a most desirable group. They should be encouraged.

In many cities the ownership of private houses has become economically impossible. To encourage urban home ownership the cooperative apartment owner should be given the same tax deductions and interest deductions that he would get if he owned a private house.

If you have any questions I should be very glad indeed to try to answer them.

Senator VANDENBERG. You say this is the chief reason for the failure of cooperative housing?

Mr. FORSTER. One of the chief reasons.

Senator DANAHER. Mr. Chairman, a question.

The CHAIRMAN. Yes.

Senator DANAHER. Is there any reason why a cooperative may not take over two apartments, live in one and rent the other?

Mr. FORSTER. No objection to his doing that, but if he does that, then the second one, the one he rents, would become a business investment, and he would then pay an income tax on the net rent he received. In other words, assuming he got $2,000 rent for the one he rented and assuming that his maintenance charges and upkeep, entire upkeep, what you would call maintenance charges, would amount to $1,000, he would then have to add to his personal income $1,000, the net difference.

Senator DANAHER. And if an individual were responsible, he might take a third one for his son, let us say?

Mr. FORSTER. Yes. If he held it in his own name, his son would pay the rent, of course. It would be treated the same way. If his son did not pay the rent, he would be entitled to the deduction.

Senator DANAHER. The only point of my inquiry, I think Mr. Eagle left the impression that one owner may only have one share in this cooperative venture. He may have as many units as he wishes.

Mr. FORSTER. The one he occupies is the only one that he gets the benefit for in regard to the taxes.

Senator TAFT. As I understand it, the owners' shares of stock are absolutely tied up in that particular apartment. They cannot be separated. They relate to that apartment and cannot be related to any other apartment; is that right?

Mr. FORSTER. That is right.

Senator TAFT. They may be transferred with the apartment, but not otherwise.

Mr. FORSTER. There is a reason why an owner would not want more stock with any apartment that he occupied. He would prefer to have less, because his maintenance charges are dependent on the number of shares of stock. If he had 10 shares and was told he could have 10 extra shares he would refuse them, because it would mean his rent would be doubled, and he naturally would want as low a rent as he could get. From that standpoint there is no danger of his getting any extra stock that would in any way help his tax situation.

The CHAIRMAN. If there are no other questions, we thank you, Mr. Forster, for appearing.

Mr. FORSTER. Thank you.

The CHAIRMAN. Mr. Ruml.

STATEMENT OF BEARDSLEY RUML, OF R. H. MACY & CO., INC., NEW YORK, N. Y.

The CHAIRMAN. You may give your name to the reporter, and your business connections.

Mr. RUML. Mr. Chairman, my name is Beardsley Ruml. I am appearing as an individual. I am the treasurer of R. H. Macy & Co. and also chairman of the Federal Reserve Bank of New York and adviser of the National Resources Planning Board.

The committee is familiar with the weakness in the American scheme of things which is caused by the universal indebtedness of income-tax payers to the Federal Government. It is my purpose to emphasize the seriousness of this weakness, to point out briefly some of the consequences, and to make a suggestion as to what may be done about it at the present time. I should like, if I may have permission, to submit for incorporation in the record a printed statement which analyzes the problem and the suggested solution in some detail.

The CHAIRMAN. You may have the privilege of filing that with the reporter if you desire to put it into the record.

Mr. RUML. Every income-tax payer on the 1st of January of this year was in debt to the Federal Government for his income tax on his income for 1941. By the time he paid the first installment on March 15, 1942, he was already in debt for the tax on his income from the 1st of January 1942 to the middle of March, so he is always in debt for the tax on about a year's income.

The situation is not a new one. The year before he was similarly in debt, and so also in the year before that, back to the first year after he had a taxable income. Generally speaking, this debt, the income tax on last year's income, was paid out of the next year's income, and, by and large, it didn't cause any difficulty; rates were low and most citizens weren't liable for any income tax, anyway. But the days of low rates and general immunity from income tax have gone, and what was once a minor defect has become a serious and growing weakness and an obstacle to urgently required tax measures.

In general, the American taxpayer is counting on paying his 1941 tax out of 1942 income. Some few, to be sure, being accounting-minded, have accrued their income taxes, but these are few, indeed. For most the desirability of accruing personal income taxes only became evident after rates became so high that it was impossible to double up—to accrue the tax on this year's income and to pay the tax on last year's income during the same year.

Nothing is to be gained by arguing that people ought to save this year's tax out of this year's income. The fact exists that they did not do it, and now they cannot do it. We need, rather, to adopt a plan which automatically shifts taxpayers to a current basis. It would have done little good to argue with employers or employees that, in order to save power, everyone ought to go to work at 8 o'clock in the morning instead of at 9; the same result in power saving was achieved much more simply by moving all the clocks forward an hour, so that we actually go to work at 8 o'clock, although we normally still go at 9.

And so, as a matter of practical fact, most income-tax payers are counting on paying their year's debt to the Federal Government out of income they haven't yet received and which will itself be subject to income tax.

Some day, for each and every taxpayer that counted-on income to pay last year's income tax will not materialize. Already today, many an income-tax payer is in difficulties because of this income-tax debt. Who are these tax payers? First of all, there are the men in the armed forces and those who have gone into Government service at lower income. Next, there are those who had been successfully employed in nonwar industries, who have seen their income shrink because of priorities and allocations, and who have not completed their adjustment to war occupation. There are the thousands and thousands who every year suffer reduced income because of accident, sickness, old age. For all of these, their income-tax debt, especially now because of the high rates, creates an intolerable situation.

And for the tens of thousands who are actually in distress, there are millions who are in danger, in danger of loss of income through being drawn into military or Government service, through wartime industrial displacement, through accident, through sickness, through retirement because they can no longer keep up the pace. To be sure, the lightning will not strike all in 1942; but it is sure to strike some of us—which, we do not know, but we are all in danger.

This danger will be increasingly felt by the people as income-tax rates go higher and as a friend here and an acquaintance there is engulfed by his income-tax debt. For the welfare and morale of the country it is a situation which is not good. We should get our income taxes on a current basis and at once. We should get out of debt to the Federal Government.

There is a compelling reason for doing something about it now. Sooner or later we shall be demobilizing our war industries and wartime incomes will cease. There will be a period of readjustment. Suppose we are still a year behind, a year in debt on income tax. Can we imagine income taxes being paid by the unemployed out of their unemployment compensation?

Finally, this income-tax debt makes difficult or impossible the full use of the withholding tax. If we did not have this debt, if we were currently tax debt free, there would be no problem of paying 2 years' taxes in 1, and a withholding tax could be imposed forthwith.

I believe I have said enough to demonstrate that the tax debt of income-tax payers is a dangerous weakness, that it causes widespread hardship and apprehension, that the danger is an increasing one, and that it obstructs desirable tax measures. I think all will agree that it would be highly desirable to get rid of this tax debt and that it is well worth while to attempt to solve this major problem even at the risk of a few minor imperfections.

The suggestion that I am offering is not being presented as the only or even as the best solution. It is the best that I and those with whom I have consulted have been able to devise. In any case, it may serve to emphasize the problem and to be a starting point for others who will have alternative and better suggestions.

The pay-as-you-go income-tax plan is intended to apply to individual income, not to corporations or to estates.

In order to get individuals free of tax debt to the Federal Government, and to keep them on a current basis from that time on, we must solve three problems.

1. How can we get on to a current basis without paying 2 years' taxes in 1 year?

2. If we are to file a tax return near the beginning of a year, how can we estimate in advance the amount of the new year's income?

3. What tax rate should be applicable to the new year's income?

Taking up these problems in order, we make these suggestions:

1. How can we get on to a current basis without paying 2 years' taxes in 1 year? We are now paying a tax in 1942. It is considered a tax on 1941 income. Suppose we move the tax clock ahead, suppose we redefine our tax and say that the tax we are paying in 1942 represents a tax on our income for 1942. In 1943 we continue to pay a tax which becomes a tax paid with respect to income which will be received in 1943. Although the tax on 1941 income drops out of existence, the Treasury continues to receive its revenue and the taxpayer continues to pay his taxes. The great difference is that the taxpayer is now on a current basis. He continues to pay his taxes every year on income received in that year. But when he dies or ceases to receive income, he does not owe a tax as he does under the present system. Reduction of tax payment by the taxpayer as a result of setting the tax clock ahead occurs only at some future date when and as the taxpayer's income increases or declines. The reduction is therefore spread over the lifetime of the present income-tax-paying generation, and occurs beneficially for each taxpayer at the time when his income fails. As for the Treasury, the Treasury has never considered taxes receivable as an asset, and accordingly they can be written off the balance sheet of the Government without the change of a single penny.

As to the second problem: If we are to pay in any given year a tax based on the income of that year, how are we to know the amount of the income? We make this suggestion: In March of each year the taxpayer should declare a tentative tax for that year, but because he does not yet know the exact amount of income for the current year, the tentative tax should be measured by the income of the preceding year; that is, a return filed on March 15, 1942, would be a return of tentative tax for 1942, based on 1941 income, rather than a tax for 1941. In the subsequent year's return, end-of-the-year adjustments would be made to correct the tentative tax to the actual tax liability. I will try to explain a little later the way in which these adjustments could be made.

The problem of how the taxpayer will know what tax rate is applicable can be solved by a technical change. Under the present system when the Congress changes the rates of tax this year, the new rates will be made applicable to 1942 income but the tax on 1942 income will not be paid until 1943. We suggest that under the pay-as-you-go plan the new rates, for taxpayers subject to the plan, be made first applicable to income received in 1943. Insofar as the Government is concerned, this change will make no difference in tax collections in 1943; under the present system, as well as under the proposal, the new rates first affect payments of income tax made in 1943.

The way in which the plan would work out in practice is perhaps made clearer by a simple example. Suppose a taxpayer received $5,000 taxable income in 1941. His return filed on March 15, 1942, showed a tax measured by the 1941 income. Under the plan this tax, instead of being his 1941 tax, would be his tentative tax on 1942 income. This tentative tax is paid in 1942. If at the end of 1942 he finds his taxable income in that year was actually $5,000,

the same amount as in 1941, his full tax has been paid and he owes the Government nothing. If at the end of 1942 he finds instead that his 1942 income was actually $5,500, he owes the Government a tax on the additional $500, but this is certainly better than his owing the Government, as under the present system, a tax on the full $5,500. This deficiency tax on the additional $500 would be payable in March of 1943 at the time his tentative tax for 1943 is returned. If at the end of 1942 he finds that his 1942 income was actually $4,500, the Government owes him a refund or a credit of the tax on the $500 differential. The tax on that amount could be credited against the taxpayer's tentative tax liability for 1943. Continuing into 1943—the taxpayer would file a return in March 1943 showing tentative tax for 1943 based on his actual 1942 income. He would pay in 1943 this tentative tax plus any deficiency that was owed for 1942 or minus any credit for an overpayment of his 1942 tax. In the same way, in each succeeding year the taxpayer would pay a tentative tax for the current year plus or minus any differential between the tentative tax and the actual tax liability for the preceding year.

For taxpayers with stable income the plan means that they owe no taxes to the Government at the end of the year. For taxpayers with increasing or decreasing income, there is ordinarily an adjustment to be made at the end of the year. However, there are some cases where it would seem to be unnecessary for the taxpayer whose income has decreased to pay his tentative tax at the high level of the preceding year and then claim a credit for the overpayment. Take, for example, the men who have gone into the armed services. Suppose a particular individual, who received $7,500 in 1941, and who is now holding a commission in the Army and receiving $2,000. Under the plan as stated he would pay tentative tax for 1942 on the basis of the $7,500; but since his actual income in 1942 is only $2,000, he would be entitled to a credit on the overpayment. We suggest that in such cases as this, where income has decreased and will clearly remain at the lower level, the taxpayer should, upon proper certification, be required to pay tax only on the lower income of the current year. In such cases provision could now be made for waiving collection of future installments payable in 1942 to the extent they exceeded the amended 1942 tax, or for crediting the taxpayer with amounts already paid in excess of that figure. We have called this the relief provision, and have suggested that it be made applicable only to income from personal services. In these cases the lower current income could be certified and tax paid only on that amount. This would give immediate relief to the taxpayer whose income has decreased, and eliminate the necessity for unnecessary payment and crediting. The relief provision could probably not be extended beyond income from personal services as the administrative difficulties might outweigh the advantages.

When income has increased in the current year over the level of the preceding year, we suggest that the taxpayer should be given the right to, and be encouraged to, make a voluntary declaration of the increase and pay tentative tax at the higher current level. At the present time it is impossible for a taxpayer to pay his tax on a high income in the year it is received, and the higher income is never reflected in tax receipts until the following year. Certain taxpayers

with fluctuating income might be glad of the opportunity to pay their taxes on the high income currently and certainly the option to do so could never operate to the disadvantage of the revenues.

I do not want to take the committee's time to go into any detailed consideration of the general effects of the plan on taxpayers and on the Government; these are outlined in the printed statement of the plan. The advantages of the plan to taxpayers are self-evident. All taxpayers would be largely freed of tax debt immediately since the larger part of their tax liabilities would be paid in the years in which the income was received. When a taxpayer died, or ceased to receive income, or came to a period when his income had markedly decreased, there would not be the additional burden of a tax debt based on the full earnings of a previous year.

We do not believe that the adoption of the plan would prejudice the revenues. Every taxpayer will continue to pay income tax every year—the only difference is that under the plan he would be paying a tax on this year's income rather than on last year's income. The skipping of a year's tax actually occurs only when the taxpayer dies or he ceases to receive income. This resulting loss of revenue is spread over the years as the current generation of taxpayers ceases to be taxpayers. This loss of revenue, spread perhaps over a period of 50 years, would be partially offset by certain increases in tax collections under the plan; and in any case could be made up by slightly higher rates over this long period of time.

Balancing any possible net loss in revenue to the Government are certain important advantages. It is as essential for the Government to collect taxes currently as it is for the taxpayer to pay them currently. The problem of delinquencies in tax collections, although it has not been serious in past years of higher exemptions and lower rates, is certain to become serious in the future if taxes are not paid on a current basis. The entire problem of tax collection in general becomes more difficult as we widen the income-tax base. The collection problem has brought to the forefront the desire for some type of withholding tax. Yet a withholding tax implies current tax collections—it does not fit well into our present tax system. In one sense, as a withholding tax becomes more desirable, our present tax-collecting system becomes more cumbersome.

The pay-as-you-go plan, although it is primarily designed as a method of getting taxpayers out of tax debt and onto a current taxpaying basis, does, however, also solve the great difficulty encountered under the present system in the imposition of a withholding tax. Under the present system it is extremely difficult to institute a withholding tax without some amount of double taxation during the transition period. The difficulty lies in the fact that under the present system taxpayers will be paying in 1943 a full year's tax on 1942 income. If withholding is instituted in 1943 against 1943 income and therefore credited against 1943 tax which is not payable until 1944, the taxpayer will have to pay in 1943 not only the full year's tax on 1942 but also the amounts withheld out of 1943 income. Even under the provision in the bill as it was passed by the House under which the withholding rate in 1943 would be 5 percent instead of 10 percent, there would still be 5 percent additional tax during both of the transition years 1943 and 1944. With the rate schedule

of the House bill this will mean that the taxpayer will be paying in 1943 a rate of 24 percent on the lowest bracket of taxable income.

Under the pay-as-you-go plan the tax paid in 1943 would be a current tax on 1943 income; therefore, amounts withheld against 1943 income could be directly credited against the installments of tentative tax on 1943 income. Further, since the amounts withheld in 1943 could be directly credited against the installments of tentative tax, the withholding rate could be set at the rate equivalent to the sum of the normal tax rate plus the lowest bracket surtax rate—19 percent, under the rates of the bill as it was passed by the House. Under the Treasury's proposal it would be impossible to set the withholding rate so high since withholding superimposed on the present system necessarily involves to a considerable extent an additional tax burden during the transition period.

In our discussions during recent months we have sincerely looked for objections and criticisms, and the plan as it now stands has profited greatly from these conversations. One criticism that the plan does not meet should be mentioned and answered.

It has been pointed out that under the pay-as-you-go plan there will be a certain number of individuals who will benefit unduly because of the fact that for them 1941 happened to be a year of unusually large income, larger than that of the years that preceded or that followed. Consequently, in selecting 1941 as the year to be omitted, they receive unintended benefits.

We concede the fact. In answer, we point out that no tax program will cut with the precision of a surgical knife. Furthermore, these few individuals could not have built up their 1941 incomes with prevision that this plan would be suggested or adopted, and therefore no deliberate manipulation of income for this purpose is involved. Insofar as there is inequity in the plan on this account, it resides in being too beneficial to some few taxpayers; but since the plan is beneficial to all and harmful to none, inequity of this kind, though regrettable, is an imperfection of a minor order as compared with the great good that will be achieved.

We believe that the problem of tax debt must be solved in some manner. As I have pointed out, the problem is an intensely personal one, affecting every taxpayer. The suggested solution offered in the pay-as-you-go plan gives relief to the taxpayer and yet does not embarrass the revenues. Whether the solution of the problem of income tax debt takes the form suggested in the pay-as-you-go plan or some other form is not important; what is important is that the problem should be solved.

Thank you very much, Mr. Chairman.

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

Senator DANAHER. Have you taken this up with the Treasury?

Mr. RUML. Not officially, but it has been discussed with a number of the experts of the Treasury.

Senator DANAHER. What do they say about it?

Mr. RUML. I think the Treasury can best speak for itself; but I will say this, that the plan as it now stands incorporates as many of the suggestions that were received from the technicians as it was possible to incorporate, with the exception of one criticism which I have specifically mentioned.

The CHAIRMAN. Are there any other questions?

Senator CLARK. Mr. Ruml, I do not see how it is that you figure this 1941 tax that is being omitted. The 1941 tax is now being paid or has already been paid.

Mr. RUML. That is true. My point is if we consider these payments as payments against 1942, then at the end of this year we all start fresh and clean, and we have a clean piece of paper to write on. So you see it is the 1941 tax that is being skipped.

Senator CLARK. The payments made in this year would be credited against this year's taxes?

Mr. RUML. That is correct, sir.

Senator CONNALLY. You would not pay any tax at all in 1941?

Mr. RUML. The 1941 tax would not be paid, but the reduction of income would only come over the whole lifetime of the present generation that is paying an income tax, because each year we go along and pay our tax as a bona fide declaration, and it is only as we die or as we lose our income——

Senator CONNALLY. I mean nobody is paying taxes on 1941 income.

Mr. RUML. 1941 would drop out, but everyone would pay what he would have paid in 1941 but pay it in 1942 against 1942 income.

The CHAIRMAN. He would pay every year?

Mr. RUML. He would pay every year, but it is on the new year, so when we come to the end of this year we are out of debt to the Government.

Senator CLARK. The taxes you pay in 1942 would be credited on the 1942 income as against 1941 income?

Mr. RUML. That is correct, sir.

The CHAIRMAN. Thank you very much for your appearance.

(The pay-as-you-go income tax plan submitted by Mr. Ruml is as follows:)

THE PAY-AS-YOU-GO INCOME TAX PLAN

[March 25, 1942, revised June 30, 1942]

The pay-as-you-go income tax plan is the result of much consultation and the working of many minds. It is offered by its friends as a possible solution of a serious national problem, the indebtedness of millions of citizens to their Government because of the present practice of assessing and collecting the Federal income tax.

BEARDSLEY RUML.

NEW YORK, N. Y., *June 30, 1942.*

THE PAY-AS-YOU-GO INCOME-TAX PLAN

The plan outlined below is proposed as a method whereby individual taxpayers can be put on a current taxpaying basis so that the income taxes they pay in any 1 year represent the taxes on that year's income rather than on the income of the preceding year.

I. THE PROBLEM

Under our present system of paying income taxes every taxpaying individual is always in debt to the Government. In 1942 we are now paying taxes on the income we received, and probably spent, in 1941; but the tax on the income we are now receiving in 1942 has not yet been paid, and by the end of 1942 we shall each owe the Government 1 year's tax. In many instances, when income continues from year to year without much change and when there is little change in the tax rates, the present system may not seem to work any hardship. We receive income in every year, and we pay a tax in every year, and we may not be concerned by the fact that the tax we have paid is on last year's income and that we still owe a tax on this year's income. Nevertheless, whether we are conscious of it or not, we are always in debt.

There are times in nearly every taxpayer's life when the existence of debt creates particular hardship. Every taxpayer dies some time; most taxpayers suffer some time during their lives a decrease in income which may be very sharp, as when an individual retires, or suffers an accident, or finds his income sharply cut by general economic dislocations. A man earning $10,000 a year may retire on an income of $3,000 a year; in the first year in which he receives $3,000 he has to find the money to pay a tax on his last year's $10,000 income. When a taxpayer dies, his estate is liable for the payment of a tax on the income he received in the year of death. But in the year in which payment is due there may be no income out of which to pay the tax. The tax, if it is paid at all, must be paid out of whatever capital the decedent leaves, which may seriously deplete the amount remaining for his surviving family. For many people the payment of tax on 1 year's income at the present high rates can be a serious problem when there is no more income coming in. The general problem which exists in peacetime as well as wartime is brought into sharp focus in the case of the men who have this year entered the armed services. Many of these men will receive during this year incomes far below their 1941 incomes; but out of their small 1942 incomes they must pay a tax on the higher incomes of the preceding year. Even though collection of this tax is deferred, the debt remains.

There are unquestionably some taxpayers who are careful enough to provide in advance for their tax liability, but they are a minority. These are the people who, for instance, in 1942, would try to estimate their probable 1942 income and their tax on that income; and would then set aside out of 1942 income funds with which to pay the tax. These people, although they owe the Government a debt, will have provided funds with which to meet it. But most taxpayers do not provide for their taxes in that manner, partly because of a general tendency not to provide for the payment of a debt until the period when the payment is due, and partly because estimating the amount of tax is often impossible.[1] For example, taxpayers have known all during this year that the tax rates applicable to 1942 income would be changed, but lacking the quality of omniscience they could not know in advance the rates which would be applicable to their particular incomes. The taxpayer, with the best will in the world, could not estimate the tax that would be due on 1942 income, even if he knew in advance the amount of his 1942 income.

Certainly the majority of people do not even try to provide in advance for their tax liability. They somehow find the money in 1942 to pay the tax for 1941, and wait until 1943 to worry about their 1942 tax. The consequence is that at the end of every year they are in debt for a year's taxes and have not provided out of their income for the payment of that debt. The present proposal is made in an effort to find some way to get taxpayers out of tax debt and on a pay-as-you-go basis, so that the tax they pay during any year is to the fullest possible extent the tax in the income received during that year, and so that at the end of the year they will not owe money to the Government.

Nothing is gained by arguing that people ought to save out of this year's income enough money to pay the tax on this year's income. The fact exists that they do not do it. We need, rather, to develop some system which automatically shifts taxpayers to a current basis. It would have done little good to argue with employers or employees that in order to save power, everyone ought to go to work at 8 o'clock in the morning instead of at 9; the same result in power saving was achieved much more simply by moving all the clocks forward an hour, so that we actually go to work at 8 o'clock, although we nominally still go at 9.

The present tax collecting system has developed out of apparent necessity. Taxes are not paid on 1941 income until 1942 because it is not until 1942 that the taxpayer knows certainly what his income was in 1941 and what rate of tax is applicable. But in spite of the seeming necessity for the present system, if it does produce unnecessary hardship, it is worth some effort to find out if there is a feasible method by which taxpayers can pay their tax on a current basis.

II. THE MAIN DIFFICULTIES IN THE WAY OF A PAY-AS-YOU-GO SYSTEM

In order to put taxpayers on a current basis, we must find some system under which the tax paid in any 1 year is the tax that is owed on the income received during that year. Three main difficulties stand in the way:

[1] Heretofore taxpayers, generally, have not been conscious of the problem, primarily because they did not have to face the possibility of paying last year's taxes and also paying, in the event a withholding tax is initiated, part of this year's taxes.

(1) Since we are 1 year behind in our tax payments, how are we going to catch up with ourselves—what do we do with the extra year?

(2) If we are to file a tax return in March of any given year, representing tax on that year's income, how are we to know in advance the amount of that year's income?

(3) If we are to file a tax return in March of any given year, representing tax on that year's income, how are we to know in advance the tax rate applicable to that year's income?

Taking up these problems in order, we make these suggestions:

(1) We are paying a tax in 1942 anyway. It is now considered a tax on 1941 income. Suppose we redefine it and say that the tax paid in 1942 represents a tax, tentative to be sure, on the income we are going to receive in 1942. In 1943 we continue to pay a tax which becomes a tax paid with respect to income which will be received in 1943. The tax on 1941 income apparently drops out of existence, but the taxpayer continues to pay a tax every year. The only difference is that he is now on a current basis. He continues to pay a tax every year on the income received or to be received that year. But when he dies or ceases to receive income, he does not owe a tax, as he does under the present system. Although the tax on 1941 income seems to have been presently canceled, cancelation actually occurs only a the time the individual ceases to be a taxpayer. As is pointed out below, so far as the Government is concerned, any loss in revenue would be largely offset by an acceleration in collection of tax from new taxpayers and from present taxpayers receiving increased incomes, and by an increase in estate-tax collections.

(2) It is perfectly clear that most taxpayers could not have filed a return, say in 1942, on the basis of their 1942 income, since they would not know the amount of the income until the end of the year. To avoid this obvious difficulty we suggest that each year a taxpayer should compute his tax for that year, measured by the income of the preceding year; that is, the return filed on March 15, 1942, would be a return of tax due on 1942 income, but because of practical necessity it would be based on the 1941 income. Suppose a taxpayer received $5,000 taxable income in 1941. His return filed on March 15, 1942, showed a tax measured by 1941 income; under the plan this would be his tentative tax on 1942 income. If at the end of 1942 he finds that his taxable income actually was $5,000, the same income as in 1941, his full tax has been paid. If he finds, instead, that his 1942 income was $5,500, he owes the Government a tax on the additional $500. (But that is far better than his owing the Government, as under the present system, a tax on the full $5,500.) If he finds that his 1942 income was $4,500, rather than $5,000, the Government owes him a refund or a credit of the tax paid on the additional $500.

(3) The problem of how the taxpayer will know what tax rate is applicable can be solved by a technical change. Under the present system, when the Congress changes the rates of tax this year, the new rates will be made applicable to 1942 income. But the tax on 1942 income will not be paid until 1943. We suggest that under the pay-as-you-go plan the new rates, for individual taxpayers subject to the plan, be made first applicable to income received in 1943.[2] The returns filed in March 1942 on the basis of the 1941 act rates could then properly represent the tentative tax on 1942 income. In March 1943 the taxpayer would use the new rates in computing the tentative tax payable in 1943 measured by 1942 income. Insofar as the Government is concerned, this change will make no difference in the tax collections in 1943; under the present system, as well as under this proposal, the new rates first affect payments of income tax made in 1943.

III. THE ESSENTIAL POINTS OF THE PAY-AS-YOU-GO PLAN

The proposed plan is intended to apply only to individual income, including partnership income and the income of trusts taxable to the beneficiary or the grantor. It would not apply to corporations, to estates, or to the income of trusts taxable to the trustee, since corporations normally report on an accrual basis, and executors and trustees necessarily provide for the payment of taxes before distribution is made.

The plan contemplates the following modifications in the present tax system. (In the following statements it is assumed that the plan goes into effect in 1942.)

[2] It could be provided, however, that the 1942 act provisions for the alternative tax with respect to capital gains and losses and the limitation on capital losses should apply to capital gains and losses realized during 1942.

(A) *Tentative tax.*—In March of each year the taxpayer would file a return showing a tentative tax for that year; the tax would in general[3] be measured by the income of the preceding year but computed according to the rates and exemptions applicable to the current year. That is, the tax shown on the return filed in 1942 would represent a tentative tax on 1942 income, measured by 1941 income but computed according to the rates and exemptions applicable to 1942 income.[4]

(B) *Changes in rates of tax and exemptions.*—Whenever changes are made in tax rates or exemptions, the new rates and exemptions, for individual taxpayers subject to the plan, would not become operative until the first of the year following enactment.[5] That is, a change in rates enacted in 1942 would be applicable to 1943 income but not to 1942 income. However, this does not postpone the effect on collections of a change in the rate scale or in the exemptions. Under the present system, a change in rates enacted in 1942 will be applicable to 1942 income, the tax on which is collected in 1943; under the proposed plan the change would first apply to 1943 income, the tax on which would also be collected in 1943.[6]

(C) *Adjustment of tentative tax to actual tax liability.*—The plan contemplates that, in general,[7] the tentative tax is to be measured by the income of the preceding year, since the actual income of the current year cannot be known until the end of that year. Therefore, at the end of each year the taxpayer may find that he has paid too little or too great a tax on the current year's income.[8] Suppose, for instance, that a taxpayer received income of $5,000 in 1941 and $5,500 in 1942. The tentative tax paid in 1942 would have been measured by his 1941 income of $5,000. At the end of 1942, since the taxpayer's income in 1942 was actually $5,500, he would owe the Government a tax on the additional $500 at rates applicable to 1942 income; this differential would be payable the following March (1943)[9] at the time the tentative tax for 1943 is returned. In the same way, if at the end of 1942 the taxpayer found that his actual 1942 income was $4,500 rather than $5,000, the Government would owe the taxpayer a refund or a credit on the differential of $500. The tax on that amount could be credited against the taxpayer's tentative tax liability for 1943.[10] No substantial administrative difficulty or expense would be involved because the taxpayer's return of tentative tax for the following year, 1943, would show his actual income for 1942; any deficiency due on 1942 income or claim for credit because of an overpayment on 1942 income would be computed and shown on the 1943 tentative tax return.[11]

Under the proposed plan (except for the operation of the relief provision outlined in III (D) below), all individuals would pay the same amount of tax in 1942 as they would under the present law, i. e., each individual would pay a tax measured by 1941 income but at the rates and exemptions applicable to 1942

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[3] See III (D) below for a suggested relief provision to take care of certain cases of increasing or decreasing income.

[4] Since we are suggesting (see (B) immediately following) that any change in rates and exemptions, except perhaps as to capital gains and losses (see footnote 2), should first become operative the first of the year following enactment, the rates and exemptions applicable to 1942 income would be the rates and exemptions of the 1941 Revenue Act. However, under the proposed plan the tax on 1942 income, computed at the 1941 net rates and exemptions, is collected in 1942; under the present system the tax collected in 1942 is also computed at the rates and exemptions of the 1941 Revenue Act.

[5] Except perhaps as to capital gains and losses, see footnote 2.

[6] The plan originally contemplated that the rates about to be enacted should be applicable to 1942 income. However, it was found that where the year of transition is one of increased rates, the increase in tax payments (as distinguished from tax liability) in the year following the year of transition is probably too steep. It is true that this burden would be more than offset by the complete or relatively complete freedom from obligation at the time of death or retirement. Moreover, the increase in tax payments in 1943 would, in most cases, probably not be substantially greater than the amount that would be payable if a withholding tax were initiated in that year. But people generally are more interested in immediate consequences than in ultimate effects.

[7] See III (D) below for a suggested relief provision to take care of certain cases of increasing or decreasing income.

[8] This would result solely from an increase or decrease in income over the preceding year, or a change in status as regards the personal exemption or credit for dependents during the preceding year.

[9] If the deficiency were very large in proportion to the total liability, provision could be made for paying it in installments.

[10] Since the overpayment could be credited against the tentative tax liability for the following year, there would, in normal times, be relatively few occasions for an actual cash refund. Refunds would ordinarily be necessary only in the case of taxpayers who had died or who had ceased to receive taxable income.

[11] An example of a return showing tentative tax for 1943 and a deficiency tax for an underpayment in 1942 is given in table VII of the appendix.

income.[12] But instead of this being a tax on 1941 income, it would be at tentative tax on 1942 income. At the end of the year 1942, if the taxpayer's 1942 income was different in amount from his 1941 income, he would owe to the Government or be owed by the Government the tax on the differential. But if at the end of 1942, he found that his 1942 income was the same as his 1941 income, his full tax on his 1942 income would be paid and there would be no differential to be adjusted. In 1943 he would pay a tentative tax measured by 1942 income but at the rates and exemptions applicable to 1943 income; this would be the same amount of tax he would pay in 1943 under the present system. However, he would also pay to the Government or be credited by the Government in 1943 for any difference in the tentative tax paid for 1942 and the actual tax liability for that year. Thus in 1943 and in each succeeding year the taxpayer would (except in cases where the relief provision outlined in III (D) might be applicable) pay a tentative tax measured by the income of the preceding year, plus or minus any differential between the tentative tax and the actual tax liability for the preceding year.

(D) *Relief provision for certain cases of increasing or decreasing income.*—Under the pay-as-you-go plan taxpayers whose income is stable from year to year would be on a completely current basis. A tentative tax for 1942, measured by 1941 income, would equal the actual tax liability for 1942; there would be no deficiency to be paid nor any overpayment to be credited in 1943.

However, for taxpayers whose income is not stable the tentative tax may be either greater or less than the actual tax liability. As in the example given in III (C) above, the taxpayer whose 1941 income was $5,000 and whose 1942 income was $5,500 would owe a deficiency equal to the tax on $500; the taxpayer whose 1941 income was $5,000 and whose 1942 income was $4,500 would be owed by the Government a refund or credit of the tax on the $500.

A relief provision could be added to allow taxpayers, in certain cases, when income had decreased or increased over the preceding year, to report a tentative tax based on the current year's income rather than on the income of the preceding year.

(1) *Decreasing income.*—In order to avoid too great administrative difficulty, the relief provision for decreasing income should probably be limited to income from personal services. In such cases it could be provided that upon proper certification of a decrease in income the taxpayer would be permitted to return tentative tax upon the basis of the lower current income. There are many obvious cases where 1942 income, for instance, has decreased from the level of 1941 income and where it is quite clear that 1942 income will remain at the lower level. The outstanding example is, of course, the taxpayers who have entered the armed services. This relief provision would allow the men in the armed services, and other taxpayers receiving income from wages and salaries who could certify that the current year's income would be at a level lower than that of the preceding year, to pay tax only on the current year's income. This provision would eliminate the necessity for the taxpayer to pay a tentative tax on the higher income of the preceding year and then claim a credit in the following year for the overpayment.[13]

(2) *Increasing income.*—When income had increased over the level of the preceding year, taxpayers could be given the right to, and be encouraged to, make a voluntary declaration of the increase and pay tentative tax at the higher current level. There would seem to be no necessity of restricting this voluntary declaration of increase in income to income from wages and salaries; instead the provision could apply to all income. To the extent to which the right to declare a higher income and pay tax at the higher current level was taken advantage of, taxpayers with increasing income would be on a completely current basis. It is impossible to know in advance to what extent taxpayers whose income had increased would voluntarily declare the higher income and pay tax at that level. However, it is unquestionably true that many taxpayers are concerned by the fact that the tax on their income in a

[12] The tentative tax paid in any year under the proposed plan would (except for the relief provision) be the same as the actual tax liability that would be paid under the present system, except if there had been a change in status as regards the personal exemption or the credit for dependents. Under the proposal the tentative tax paid, for example, in 1943 would be computed according to the taxpayer's status with regard to the personal exemption and credit for dependents as of the beginning of the year; if the status had changed during the preceding year, the tentative tax under the proposal would be slightly different from the actual tax that would be paid that year under the present system.

[13] To safeguard the revenues an interest penalty could attach to any deficiency resulting from an unwarranted or false certification of a decrease in income.

particularly high income year is not currently paid but becomes a liability to be met in the following year. Although it is also true that these taxpayers probably do not accrue their taxes, they might welcome the opportunity to pay taxes on the high income in the year it was received. At the present time it is impossible for a taxpayer to pay his tax on a current high income and the higher income is never reflected in tax receipts until the following year. Even if taxpayers as a whole did not take advantage of the right to pay taxes at the level of their higher current income, the right to do so could never be to the disadvantage of the revenues.

The relief provision, although it could clearly not be extended too broadly because of possible administrative problems, could nevertheless take care of the most flagrant difficulties. It could cover almost completely the men who have entered the armed forces or other Government services, and would reach to a great extent the problem of the men whose economic status has been changed through the conversion of plant to war industry. Further, when a taxpayer retires and expects to receive in the future either no income or markedly lower income, the operation of the relief provision would eliminate the necessity for the payment of tentative tax in income which would not be received followed by the repayment of the tax in the form of a refund or credit.

IV. ADVANTAGE OF THE PAY-AS YOU-GO PLAN OVER THE PRESENT SYSTEM IN CONNECTION WITH THE INSTITUTION OF A WITHHOLDING TAX

The pay-as-you-go plan is offered primarily as a method of getting taxpayers out of tax debt and onto a current taxpaying basis. However, the plan also solves the great difficulty encountered under the present system in the imposition of a withholding tax. Under the present system, it is extremely difficult to institute a withholding tax without some amount of double taxation during the transition period. The difficulty under the present system lies in the fact that taxpayers would be paying in 1943 a tax on 1942 income. If withholding is instituted in 1943 against 1943 income (and therefore credited against 1943 tax which is not payable until 1944), the taxpayer will be paying in 1943 not only the tax on 1942 income but also the amounts withheld out of 1943 income. Even under the Treasury proposal under which 50 percent of the amounts withheld in 1943 would be credited against taxes on 1942 income, there would be additional taxation during the transition years 1943 and 1944 equal to approximately one-half the amount of the withholding rate.[14]

Under the pay-as-you-go plan the tentative tax paid in 1943 would be a tax on 1943 income; therefore amounts withheld against 1943 income could be directly credited against the instalments of tentative tax on 1943 income. At most the additional tax during the transition period would be equal to the amount withheld for 1 month. Further, since the amounts withheld in 1943 could be directly credited against the installments of tax payable in 1943, so that there would be practically no double tax burden, the withholding rate could be set at the rate equivalent to the sum of the normal tax rate plus the lowest bracket surtax rate—18 percent, under the rates adopted by the Ways and Means Committee. Under the Treasury's proposal it would probably be impossible to set the withholding rate so high, since withholding superimposed on the present system necessitates an additional tax burden during the transition period.

The pay-as-you-go plan, combined with a withholding tax, might operate as follows:

Suppose a taxpayer (married with no dependents) receives income from wages or salary amounting to $3,000 in both 1942 and 1943. He would report in 1943 tentative tax of $306, payable in four installments of $76.50. The amounts withheld during 1943 (at a rate of 18 percent) would be $25.50 a month. Against the installment of tentative tax due March 15, 1943, the taxpayer could credit the amounts withheld during January and February 1943, equaling $51, and pay the balance of $25.50. Against the installment due June 15 the taxpayer could credit the amounts withheld in March, April and May, amounting to $76.50—and would therefore owe no balance. Against the installments due September 15 and December 15 the taxpayer would likewise be able to credit the amounts withheld during a three months' period and therefore owe no balance. The total effect would be that his payments in 1943—the amounts actually paid plus the

[14] Under the modified Treasury proposal whereby the withholding rate in 1943 would be 5 percent rather than 10 percent, there would still be an additional tax of 5 percent during the transition years 1943 and 1944.

amounts withheld—would be $331.15; during this transition period the only increase in tax caused by the institution of a withholding system would be the amount of $25.50 withheld during 1 month.[15]

V. GENERAL EFFECTS OF THE PLAN

(A) *From the viewpoint of the Government.*—(1) The Treasury would collect in 1942 substantially[16] the same amount that it would under existing law. Therefore, the Government's cash position in that year would not be disturbed by the change-over. Similarly in 1943 (except with respect to taxpayers who die during 1942[17]) the Treasury would collect in cash at least as much as it would under the existing system. This is because the tentative tax paid in 1943 would be a tax measured by 1942 income but computed according to the new rates applicable to 1943 income; under the present system the actual tax collected in 1943 would be a tax on 1942 income at the new rates applicable to 1942 income. Further, the Government would collect in March 1943 any deficiencies representing the excess of the actual tax liability over the tentative tax on 1942 income. Since 1942 is expected, on the whole, to be a year of higher income than 1941, it may reasonably be anticipated that the deficiencies due in 1943 would exceed the refunds or credits in that year.[18]

(2) Nevertheless, it is true that in 1943 the Treasury would not, under the proposed plan, collect the tax on the 1942 income of decedents who died in 1942. This loss of tax would, however, be at least partially offset, and perhaps more than offset, by the following increases in tax collections that would occur under the plan.

(*a*) There would be an acceleration in the collection of tax from new taxpayers—those whose incomes first reached a taxable level during the preceding year. In 1943 a taxpayer whose 1942 income first brought him into the taxpaying group would be liable for tentative tax based on his 1942 income; he would also be liable for a deficiency tax measured by his 1942 income (since he would not have returned a tentative tax in 1942). Although the plan contemplates that deficiency taxes on 1942 income are ordinarily to be paid in March 1943, the extra burden on the new taxpayer might be mitigated by allowing his deficiency tax to be paid in installments.[19] The amount of the deficiency tax, however payable, would nevertheless represent an increase over the collections which would be received in 1943 under the present system.

(*b*) There would also be an acceleration in the collection of tax on an increase of income received in 1942 over income received in 1941. Under the plan, an increase in income in 1942 would result in a deficiency tax payable in March 1943 which would be in addition to the tentative tax payable in installments in 1943 on 1943 income. The amount of this deficiency tax also represents an increase over the collections which would be received in 1943 under the present law.

(*c*) Further, there would be some increase in estate tax. Under the plan the estate would not be liable for the tax on the income of a decedent in the year of death, since the tax would have been paid currently.[20] The net estate would,

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[15] An alternative plan for combining a withholding tax with the pay-as-you-go plan would entirely eliminate any additional taxation during the transition period. The taxpayer could return in 1943 tentative tax based on 1942 income, deduct from that tax the amount that would be withheld in 1943 at that income level, and pay merely the balance. Any change in 1943 income over 1942 income would affect both the amount of the actual tax liability and the amount withheld in 1943; both of these amounts could be adjusted at one time and a deficiency paid or an overpayment credited in March 1944.

[16] The Treasury would collect exactly the same amount were it not for the relief provision suggested under III (D).

[17] And also with respect to taxpayers who receive decreased income in 1943, and where certification is made under the relief provision (see III (D)).

[18] The refunds and credits would be made only to those persons whose 1942 incomes were lower than their 1941 incomes. This group would consist, to an overwhelming extent, of people who either gave up lucrative positions to enter the Army, Navy, or other Government service at lower pay, or were thrown out of employment by reason of the economic dislocations resulting from the war. The plan would thus afford some relief to such persons.

[19] If a withholding tax is initiated in 1943, the tentative tax on the 1943 income of the new taxpayer would be largely collected at the source, and only the deficiency tax would need to be paid in installments. If a withholding tax becomes a permanent part of the tax structure, no difficulty will arise with respect to persons who first become taxpayers in future years. For instance, a person whose income first brought him into the taxpaying group in 1943 would have paid tax in 1943 through the withholding provisions, and would therefore not owe a deficiency tax in 1944.

[20] The maximum for which the estate could be liable would be the tax on 2½ months' income (the period between the beginning of one quarter and the due date for payment of tax on that quarter, e. g., April 1–June 15), plus any unpaid deficiency tax on the previous year's income.

therefore, be increased by the amount of that tax liability and, if the estate were taxable, the estate tax would be increased by the amount of tax on the increase in value of the net estate.

(3) Any cancelation in tax that would occur under the plan would be a cancelation with respect to present taxpayers only. New taxpayers would immediately be on a current basis and as to them there would be no possible loss in tax receipts. Any net loss in tax receipts which might result under the plan would last only during the taxpaying period of the present generation of taxpayers.

(4) Under the plan a withholding tax could be instituted at any time without hardship. As outlined in IV above, the instituting of a withholding tax in conjunction with the plan would not necessitate the payment of more than 1 year's income taxes in any 1 year, as it would under the present system where a withholding tax on 1943 income would have to be credited, at least in part, not against taxes paid in 1943, but against taxes on 1943 income payable in 1944. Further, a withholding tax imposed in connection with the plan could be set during the transition period at a higher rate than under the Treasury proposal, and thereby a larger proportion of the tax collected at the source.

(5) Nominally the Treasury would lose a potential asset, i. e., income taxes receivable. However, from a practical viewpoint this is hardly a serious disadvantage, since the Treasury does not carry this asset in its balance sheet. Moreover, the loss of this potential asset would be counterbalanced to a considerable extent by an increase in another potential asset, estate taxes receivable.

(6) In a period of rising income the Treasury's collections would be accelerated. An inflationary rise in income would be counteracted to some degree, at least, by the collection of higher taxes,[21] with a consequent diminution of spending power. On the other hand, in a period of declining income, the Treasury's net collections would be reduced sooner, leaving in the hands of taxpayers an increased amount for spending at a time when they need it and should have it. The refunds of taxes might minimize the Government's relief obligations.

(7) Delinquencies in the collection of taxes would be virtually eliminated.[22] This is extremely important. In any future period of depression and unemployment there will be grave danger of wholesale defaults in payment of tax liabilities.[23] At such a time the Government will be unlikely to enforce collection; collection of last year's taxes out of current unemployment benefits would hardly be expedient. The whole tax collection system may be subjected to too severe a strain. The danger to the self-assessment system which is inherent in tax debt should be eliminated before we face the unknown economic dislocations which may follow the end of the war.

(8) The entire Nation would gain in morale if taxpayers could be relieved of the worry of their last year's income taxes. Many people who are faced with a reduction in their income or with possible temporary unemployment now have the additional problem of an income-tax debt based on a previous year's income. Their economic position would be far less precarious if they could pay their income taxes in the same year in which they received the income. This is particularly true at the present time when the war is affecting the incomes of many individuals, such as the men going into the armed forces and the industrial workers who are emporarily thrown out of employment during the shift from peacetime to wartime production. These men would be greatly aided if in the year of reduced income they were liable only for a reduced tax.

(B) *From the viewpoint of the taxpayer.*—(1) In a period of stable incomes and stable tax rates, individual taxpayers would be at all times solvent so far as income tax liability is concerned.[24]

(2) In a period of rising incomes, individual taxpayers would in nearly all cases have paid the major portion of their tax liabilities in the year in which the income was earned, and could therefore more easily adjust their spendable income to their actual income after deducting tax liability.

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[21] This results from the fact that in a period of increasing incomes there would be a deficiency tax on the preceding year's income to be paid in March; the amount of the deficiencies represents an increase in tax collections under the proposed plan as compared with the present system.

[22] The resultant saving in administrative expense would probably compensate for the increase in expense that a large number of refunds might necessitate. However, as stated in footnote 10, the number of actual refunds in normal times would be relatively low.

[23] With exemptions as low as they now are, the number of taxpayers who would be in default in the event of a depression and period of unemployment would be tremendous.

[24] Except as to a maximum of 20.83 percent of the annual tax. (This percentage is the proportion of 2½ months to 12 months. See footnote 20.)

(3) In a period of declining incomes, individuals would be entitled to refunds, which would ease the hardship of reduced income.

(4) When an individual died, his heirs would be free of the burden of paying any income taxes except as to any deficiency that might be due to increased income (and also a current tax on a maximum of 2½ months' income during the year of death). On the other hand, if the individual left an estate large enough to be subject to estate tax, the latter tax would be higher by reason of the elimination of the income tax liability.

(5) If an individual retired, say on a pension equal to half pay, he would nominally, except for the operation of the relief provision, have to pay a tax in the year of half pay measured by the year of full pay; but actually he would be subject to tax on only the half pay, and if he paid a tentative tax based on the full pay, he would be entitled to a refund at the end of the year.

(C) *From the viewpoint of the employer.*—Employers would benefit from the plan because their employees, when they retired, would not have a tax debt based on their previous full earnings; or if they died, their estates would not be liable for taxes on previous earnings. The employer would not have even a moral obligation to put the retired employee or the decedent's heirs in funds with which to meet tax liabilities. The plan would tend to accelerate retirements of executives and avoid prolongation of employment beyond the point of decreasing efficiency.

VI. SOME EXAMPLES

In all of these examples it is assumed that the taxpayer is married and has no dependents.[25]

(A) Adams has an income of $5,000 in 1941, gradually increasing by $500 increments to $6,500 in 1944. In 1942, under the present system he would pay a tax on 1941 income at 1941 act rates amounting to $375. Under the proposed system he would pay in 1942 a tentative tax on 1942 income measured by 1941 income and at 1941 act rates—also amounting to $375. At the end of 1942, since his actual income had been $5,500 rather than $5,000, he would owe the Government a tax on the additional $500 computed at 1941 act rates—amounting to $63. This deficiency tax would be payable in March 1943. In March 1943, under the proposed system, he would return a tentative tax measured by 1942 income at the new rates applicable to 1943 income—amounting to $822; this is the same amount that he would pay in 1943 as an actual tax liability under the present system. However, under the proposed plan his actual payments in 1943 would be the tentative tax of $822 on 1943 income, payable in installments, plus the deficiency of $63 on 1942 income, payable in March, a total of $885. If he dies at the end of 1944, under the proposed plan his estate would be liable for only the deficiency of $122 on 1944 income; while under the present system his estate would be liable for tax on the full 1944 income—amounting to $1,066 (table I).

(B) Baker, an engineer, whose 1941 taxable income amounted to $7,500, obtains a commission in the armed forces. His taxable income in 1942 is $2,000. Under existing law he will have to either pay a tax of $770 on his 1941 income out of the $2,000, or carry over a debt until the end of the war. Under the proposed plan without the operation of the relief provision, Baker would still nominally be required to pay $770 in 1942, but at the end of the year he would be entitled to a refund of $728. Since he would be entitled to this refund, there would be a clear case for the operation of the relief provision. The Treasury could waive collection of the full tax measured by 1941 income and substitute a tentative tax measured by the lower 1942 income. If at the beginning of 1944 Baker returns to private life and to his former taxable income level of $7,500, he would in 1944 be required to pay a tentative tax on only $2,000. This would also be the result under existing law and may be all to the good as the period following his return to private life is likely to be one of readjustment requiring capital expenditures. However, in the absence of a withholding tax, Baker in 1945 would have to make good the deficiency of $1,190 on 1944 income, and also pay a tentative tax of $1,322 on 1945 income based on an income of $7,500. Admittedly, it would be difficult to pay a total tax of $2,512 out of an income of $7,500. This difficulty could be partially met by a withholding tax on the $7,500 received in 1944; further, under the suggested relief provision, Baker would have the option of paying tax in 1944

[25] When the "new rates" are mentioned, reference is to the rates tentatively adopted by the Committee on Ways and Means.

on the income of that year rather than on the low income of the preceding year. Whatever difficulty exists pales before the prospect of his widow's having to pay a tax of $1,322 out of an income of possibly zero, if Baker dies toward the end of the year (tables IV and IV-A).

(C) Clark, a worker in a defense plant, earned $2,500 in 1941. In 1942 he will earn $4,000. Under existing law, and under the proposed plan as well, Clark in 1942 would pay $90. However, in 1943, whereas his payments under existing law at the new rates would be only $594, his payments under the proposed plan would be $663. This increase in tax will hurt less if it comes when Clark is earning $4,000 than if it comes when he dies or when he returns to his former income level of $2,500 (tables V and V-A).

(D) Daniel has a fixed annual income of $10,000. In 1942 he will pay under both existing law and the proposed plan $1,305. In 1943 he will pay $2,064 at the new rates under both the existing law and the proposed plan; this increase is due wholly to the increase in rates. Under the plan, however, his estate would be saved an income tax liability, assuming he died at the end of 1944, of $2,064. The net income tax saving would be equal to the tax on 1941 income plus the difference in the tax on 1942 income computed at the new rates and at the 1941 net rates; but if Daniel left a taxable estate, part of the saving would be offset by the increase in estate tax liability (table III).

(E) Edwards, an industrialist, has an income of $100,000 per year. He has a net estate for Federal estate tax purposes of $2,000,000. In 1942 he will pay $52,704. In 1943 he would, under the proposed plan, pay $63,072, the same amount that would be payable under the present system. If he died at the end of the year, the plan would save his estate an income-tax liability of $63,072, but the estate tax on his estate would be increased by $23,964. This assumes that Edwards will have spent only such part of his income as is left to him after taxes, and has left his capital intact. This, however, is a likely assumption (table VI).

APPENDIX

TABLE I.—*Effect of the plan assuming an increasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$5,000	$5,500	$6,000	$6,500	[2] 0	.....
(b) Tax liability under present system	375	822	944	1,066	0	.....
(c) Tax liability under proposal	.....	[3] 438	944	1,066	0	$2,448
(d) Tax paid March-December under present system	.....	375	822	944	$1,066	3,207
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	375	822	944	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	+63	+122	+122	0	.....
(g) Total actually paid each year [4]	.....	375	885	1,066	122	[5] 2,448

TABLE I-A.—*Effect of the plan assuming an increasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$10,000	$11,000	$12,000	$13,000	[2] 0	.....
(b) Tax liability under present system	1,305	2,388	2,744	3,108	0	.....
(c) Tax liability under proposal	.....	[3] 1,551	2,744	3,108	0	$7,403
(d) Tax paid March-December under present system	.....	1,305	2,388	2,744	$3,108	9,545
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	1,305	2,388	2,744	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	+246	+356	+364	0	.....
(g) Total actually paid each year [4]	.....	1,305	2,634	3,100	364	[5] 7,403

Footnotes at end of table V.

TABLE I-B.—*Effect of the plan assuming an increasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$100,000	$110,000	$120,000	$130,000	[2] 0	.....
(b) Tax liability under present system	52,704	71,448	79,848	88,248	0	.....
(c) Tax liability under proposal	.....	[3] 59,589	79,848	88,248	0	$227,685
(d) Tax paid March-December under present system	.....	52,704	71,448	79,848	$88,248	292,248
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	52,704	71,448	79,848	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	+6,885	+8,400	+8,400	0	.....
(g) Total actually paid each year [4]	.....	52,704	78,333	88,248	8,400	[5] 227,685

TABLE II.—*Effect of the plan assuming a decreasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$6,500	$6,000	$5,500	$5,000	[2] 0	.....
(b) Tax liability under present system	604	944	822	708	0	.....
(c) Tax liability under proposal	.....	[3] 521	822	708	0	$2,051
(d) Tax paid March-December under present system	.....	604	944	822	$708	3,078
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	604	944	822	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (+) following March	.....	−83	−122	−114	0	.....
(g) Total actually paid each year [4]	.....	604	861	700	[6] −114	[5] 2,051

TABLE II-A.—*Effect of the plan assuming a decreasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$13,000	$12,000	$11,000	$10,000	[2] 0	.....
(b) Tax liability under present system	2,103	2,744	2,388	2,064	0	.....
(c) Tax liability under proposal	.....	[3] 1,817	2,388	2,064	0	$6,269
(d) Tax paid March-December under present system	.....	2,103	2,744	2,388	$2,064	9,299
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	2,103	2,744	2,388	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	−286	−356	−324	0	.....
(g) Total actually paid each year [4]	.....	2,103	2,458	2,032	[6] −324	[5] 6,269

TABLE II-B.—*Effect of the plan assuming a decreasing income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$130,000	$120,000	$110,000	$100,000	[2] 0	.....
(b) Tax liability under present system	73,389	79,848	71,448	63,072	0	.....
(c) Tax liability under proposal	.....	[3] 66,489	71,448	63,072	0	$201,009
(d) Tax paid March-December under present system	.....	73,389	79,848	71,448	$63,072	287,757
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	73,389	79,848	71,448	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	−6,900	−8,400	−8,376	0	.....
(g) Total actually paid each year [4]	.....	73,389	72,948	63,048	[6] −8,376	[5] 201,009

Footnotes at end of table V.

TABLE III.—*Effect of the plan assuming a stable income*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total, 1942–45
(a) Net income	$10,000	$10,000	$10,000	$10,000	[2] 0	
(b) Tax liability under present system	1,305	2,064	2,064	2,064	0	
(c) Tax liability under proposal		[3] 1,305	2,064	2,064	0	$5,433
(d) Tax paid March-December under present system		1,305	2,064	2,064	$2,064	7,497
Tax paid under proposal:						
(e) Tentative tax—March-December		1,305	2,064	2,064	0	
(f) Deficiency to be paid (+) or excess to be refunded (—) following March		0	0	0	0	
(g) Total actually paid each year [4]		1,305	2,064	2,064	0	[5] 5,433

TABLE IV.—*Effect of the plan on a hypothetical person serving in the armed forces in 1942 and 1943 at an income of $2,000 and returning to his original income level in 1944*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total, 1942–45
(a) Net income	$7,500	$2,000	$2,000	$7,500	$7,500	
(b) Tax liability under present system	770	132	132	1,322	1,322	
(c) Tax liability under proposal		[3] 42	132	1,322	1,322	$2,818
(d) Tax paid March-December under present system		770	132	1,322	132	[7] 2,356
Tax paid under proposal:						
(e) Tentative tax—March-December		770	132	132	1,322	
(f) Deficiency to be paid (+) or excess to be refunded (—) following March		—728	0	+1,190	0	
(g) Total actually paid each year [4]		770	[6] —596	132	2,512	[8] 2,818

TABLE IV-A.—*Effect of the plan on a hypothetical person serving in the armed forces in 1942 and 1943 at an income of $2,000 and receiving no income in 1944*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	Total 1942–44
(a) Net income	$7,500	$2,000	$2,000	[2] 0	
(b) Tax liability under present system	770	132	132	0	
(c) Tax liability under proposal		[3] 42	132	0	$174
(d) Tax paid March-December under present system		770	132	132	1,034
Tax paid under proposal:					
(e) Tentative tax—March-December		770	132	0	
(f) Deficiency to be paid (+) or excess to be refunded (—) following March		—728	0	0	
(g) Total actually paid each year [4]		770	[6] —596	0	[5] 174

Footnotes at end of table V.

TABLE V.—*Effect of the plan on a hypothetical person receiving increased income in war industry during 1942 and 1943, and returning to his original income level in 1944*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	1945	Total 1942-45
(a) Net income	$2,500	$4,000	$4,000	$2,500	$2,500	.....
(b) Tax liability under present system	90	504	504	219	219	.....
(c) Tax liability under proposal	.....	[3] 249	504	219	219	$1,191
(d) Tax paid March-December under present system	.....	90	504	504	219	[10] 1,317
Tax paid under proposal:						
(e) Tentative tax—March-December	.....	90	504	504	219	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	+159	0	−285	0	.....
(g) Total actually paid each year [4]	.....	90	663	504	[11]−66	[12] 1,191

TABLE V-A.—*Effect of the plan on a hypothetical person receiving increased income in war industry during 1942 and 1943, and no income in 1944*

MARRIED PERSON—NO DEPENDENTS [1]

	1941	1942	1943	1944	Total 1942-44
(a) Net income	$2,500	$4,000	$4,000	[2] 0	.....
(b) Tax liability under present system	90	504	504	0	.....
(c) Tax liability under proposal	.....	[3] 249	504	0	$753
(d) Tax paid March-December under present system	.....	90	504	$504	1,098
Tax paid under proposal:					
(e) Tentative tax—March-December	.....	90	504	0	.....
(f) Deficiency to be paid (+) or excess to be refunded (−) following March	.....	+159	0	0	.....
(g) Total actually paid each year [4]	.....	90	663	0	[5] 753

[1] The tax liability on 1941 income is computed according to the 1941 act rates. The tax liability on 1942-45 income under the present system is computed according to the rates tentatively adopted by the Committee on Ways and Means; under the proposal the new rates (except for the alternative tax on capital gains and losses) would apply to income received beginning Jan. 1, 1943, and therefore the tax liability on 1942 income under the proposal is computed according to the 1941 act rates. It is assumed that there is no taxable income from Government obligations, and the maximum earned income credit is allowed. The tax liabilities in all of the tables are computed without reference to the relief provision suggested in III (D), except as noted in footnote 2.

[2] Assuming that at the end of the preceding year the taxpayer dies (or ceases to receive taxable income and certification is made under the relief provision that no income will be received during the current year).

[3] Tax on 1942 income at 1941 act rates.

[4] This total is the tentative tax payable under the proposal March to December plus or minus any deficiency to be paid or any excess to be refunded for the previous year.

The difference between item (*d*) and item (*g*) equals the tax on the 1941 income, plus the difference in tax on 1942 income computed according to the new rates and the 1941 act rates.

[5] Refunded March 1945.

[7] Under the present system, the liability of $1,322 on 1945 income would be paid in 1946, so that the total payments on 1941-45 income would be $3,678.

[8] Refunded.

[9] The difference between item (*d*) and item (*g*) of $462 plus the tax liability on 1945 income ($1,322) to be paid, under the present system, in 1946 (not shown in row (*d*) of the table) amounts to $860, which equals the tax on 1941 income, plus the difference in tax on 1942 income computed according to the new rates and the 1941 act rates.

[10] Under the present system, the liability of $219 on 1945 income would be paid in 1946, so that the total payments on 1941-45 income would be $1,536.

[11] Refunded March 1946.

[12] The difference between item (*d*) and item (*g*) of $126 plus the tax liability on 1945 income ($219) to be paid, under the present system, in 1946 (not shown in row (*d*) of the table) amounts to $345, which equals the tax on 1941 income, plus the difference in tax on 1942 income computed according to the new rates and the 1941 act rates.

TABLE VI.—*Increase in estate tax partially offsetting decrease in income tax: Net tax effect of plan*

MARRIED PERSON—NO DEPENDENTS [1]

Average net income (1)	Net estate before exemption [2] (2)	Decrease in income tax under plan (tax on (1) at 1942 act rates) [3] (3)	Increase in net estate under plan (tax on (1) at 1942 act rates) [4] (4)	Increase in estate tax under plan (estate tax on (4) at 1942 act rates) [5] (5)	Net tax effect of plan (3)−(5) (6)
$5,000	$10,000 (x)	−$708	$708	0	−$708.00
	100,000 (y)	−708	708	+$150.10	−557.90
$10,000	20,000 (x)	−2,064	2,064	0	−2,064.00
	200,000 (y)	−2,064	2,064	+586.18	−1,477.82
$25,000	50,000 (x)	−8,982	8,982	0	−8,982.00
	500,000 (y)	−8,982	8,982	+2,586.82	−6,395.18
$50,000	100,000 (x)	−24,840	24,840	+5,856.48	−18,983.52
	1,000,000 (y)	−24,840	24,840	+7,799.76	−17,040.24
$100,000	200,000 (x)	−63,072	63,072	+17,407.87	−45,664.13
	2,000,000 (y)	−63,072	63,072	+23,964.10	−39,107.90

[1] The following assumptions are made for the purposes of this table:

(*a*) Income is relatively stable, so that the income in 1941, the income tax on which is canceled under the plan, is of the same magnitude as income in the year of death, the tax on which measures the increase in the value of the net estate under the plan.

(*b*) Two assumptions are made as to the size of the net estate before exemption which corresponds to a given income level: If the income is entirely salary income, the net estate may be roughly equivalent to 2 years' income (assumption labeled "x"); if the income is entirely dividend income the net estate may be roughly equivalent to the income capitalized at 5 percent (assumption labeled "y"). (No adjustment has been made, however, for the earned income credit under the assumption that the income is entirely dividend income—the maximum earned income credit is allowed in the computation of the tax.)

[2] The net estate before exemption is assumed to be the net estate before exemption after deduction of the tax liability for the year of death (as under the present system).

[3] The decrease in income tax is equivalent to the tax on 1 year's income at the new rates; or, in other words, the tax on (1) at 1941 act rates, plus the difference between the tax on (1) at the new rates and at 1941 act rates.

[4] Under the proposed plan, the income tax on the income of the year of death would not be a liability of the estate as under the present system, but would have been paid in the year the income was received; the net estate would therefore be increased, under the plan, by the amount of the tax. The tax is computed according to the income tax rates tentatively adopted by the Committee on Ways and Means.

[5] This is the increase in the net federal tax, after allowance of the maximum credit for State death taxes. The tax is computed according to the 1941 act rates after allowing the estate tax exemption tentatively adopted by the Committee on Ways and Means.

TABLE VII.—*Simplified example of a return showing tentative tax for 1943 and deficiency tax for an underpayment in 1942*

MARRIED PERSON—NO DEPENDENTS

Income-tax return for calendar year 1943

INCOME FOR 1942		DEDUCTIONS IN 1942—continued	
Items 1–9 as on present return.		17. Total deductions in items 11 to 16	$400
10. Total income in items 1 to 9	$5,400		
DEDUCTIONS IN 1942		18. Net income (item 10 minus item 17))	5,000
Items 11–16 as on present return.			

Computation of tax payable in 1943

COMPUTATION OF TENTATIVE TAX FOR 1943 [1]		
19. Net income (item 18 above)		$5,000
20. Less: Personal exemption	$1,200	
21. Credit for dependents		
		1,200
22. Balance (surtax net income)		3,800
23. Less: Item 4 (a) above	$---	
24. Earned income credit	500	
		500
25. Balance subject to normal tax		3,300
26. Normal tax (6 percent of item 25)		198
27. Surtax on item 22		510
28. Total (item 26 plus item 27)		708
29. Total tax (item 28 or line 16, schedule F)		708
Items 30 and 31 as on present return.		
32. Balance of tentative tax (item 29 minus items 30 and 31)		708

COMPUTATION OF DEFICIENCY TAX OR CREDIT FOR 1942 [2]		
33. Net income (item 18 above)		$5,000
34. Less: Personal exemption	$1,500	
35. Credit for dependents		
		1,500

COMPUTATION OF DEFICIENCY TAX OR CREDIT FOR 1942 [2]—continued		
36. Balance (surtax net income)		$3,500
37. Less: Item 4 (a) above		
38 Earned income credit	$500	
		500
39. Balance subject to normal tax		3,000
40. Normal tax (4 percent of item 39)		120
41. Surtax on item 36		255
42. Total (item 40 plus item 41)		375
43. Total tax (item 42 or line 16, schedule F) [3]		375
Items 44 and 45 comparable to items 30 and 31 on present return.		
46. Actual tax liability for 1942 (item 43 minus items 44 and 45)		375
47. Tentative tax reported for 1942 on 1942 return		[4] 312
48. Deficiency tax or credit for 1942 (item 46 minus item 47)		63
49. Total tax payable in 1943 (item 32 plus or minus item 48)		771

[1] Computed according to the 1942 act rates and exemptions. (The rates and exemptions used in this table are those adopted by the Committee on Ways and Means.)

[2] The actual tax liability for 1942 (item 46) is computed according to the 1941 act rates and exemptions.

[3] An additional schedule would have to be provided for the computation of the alternative tax.

[4] Assuming that 1941 income was $4,500.

Among the persons who have examined and approved the pay-as-you-go income-tax plan are the following:

Evans Clark, director, Twentieth Century Fund, New York, N. Y.
Linus Coggan, vice president, Corn Products Refining Co., New York, N. Y.
A. L. Cole, general manager, Reader's Digest Association, Inc., Pleasantville, N. Y.
Norris Darrell, partner, Sullivan & Cromwell, New York, N. Y.
V. A. Johnston, vice president, A. G. Becker & Co., New York, N. Y.
Clarence Manion, dean, Notre Dame Law School, South Bend, Ind.
Beardsley Ruml, treasurer, R. H. Macy & Co., New York, N. Y.
Victor H. Stempf, partner, Touche, Niven & Co., New York, N. Y.
W. B. Stokely, Jr., president, Stokely Bros. & Co., Indianapolis, Ind.

The CHAIRMAN. There are two other witnesses here.

The Senate will be in session at 12. We will have to ask those witnesses to come back at 2 o'clock this afternoon.

I would like the members of the committee to be on hand at 2 o'clock, so we may have an executive session.

(Whereupon, at 11:59 a. m., a recess was taken until 2 p. m. of the same day.)

AFTERNOON SESSION

(Pursuant to the adjournment for the noon recess, the hearing was resumed at 2 p. m.)

The CHAIRMAN. The committee will come to order.

We will, if possible, finish the list of witnesses for today before going into executive session.

Is Mr. Lapp in the room?

Mr. LAPP. Yes, sir.

The CHAIRMAN. You are Grover W. Lapp?

Mr. LAPP. Yes, sir.

STATEMENT OF GROVER W. LAPP, LE ROY, N. Y.

Mr. LAPP. I am appearing on the subject of paying for the war as we go by correct taxation and finance.

We know that wars are paid for, but this would enable us to pay as we go, continuously.

I would like to read this, if I may.

The CHAIRMAN. Do you wish to use the whole statement you have prepared?

Mr. LAPP. I would like to include it all, sir.

It is condensed on the front page and then is given in more detail in the body.

Now, this is, in general, so different a proposition that it needs a full explanation. In paying, our proposition contrasts with the present system of paying only about one-third of the National, State, and local requirements for this war with the proposal of paying entirely as we go.

It sounds fantastic, I know, to begin with; but my arguments, I think, are perfectly logical, and instead of writing off two-thirds as a deficit in financing, which will be practically ruinous, this proposes to take care of it through cash at the time.

Senator CONNALLY. All of it is sales tax?

Mr. LAPP. It is all by income tax, sir; not by sales tax.

The CHAIRMAN. All right, you may proceed.

Mr. LAPP. I will begin with my condensed statement or summarization, following the same with my more detailed statement to which it pertains.

PAYING FOR WAR AS WE GO BY CORRECT TAXATION AND FINANCE

The attached memorandum is the outcome of many years of analysis of traditional views and practices in the field of taxation and finance.

These critical times require a new, adequate, basic plan for handling the problem of financing the war without destroying civilian production.

The background cause of derangement in our economy is the unfairness of exchange among individuals, enterprises, and Government. Insolvency and unemployment result.

Unfairness and loss in exchange are due to erroneous handling of the two fundamental relations by which we serve each other.

The first continuing violation of our trade relations is the use in exchange of bank credit money that was never before received for delivering anything to anybody. If borrowers of new bank credit take, say, 1 percent of the values being bought, our market is 1 percent unfair, enough to throw a certain large number of marginal individuals and enterprises into a loss and failure and unemployment.

The second way we damage our economy is by taxation of property and savings. We should tax the net income from current production of solvent people. Taxation of the transactions of marginal concerns forces another large group to suspend production and discharge producing, self-supporting, taxpaying people, who then must be supported on relief by additional taxes.

At this time Government is confronted by a broken down exchange rigidified by price controls. We should have free prices controlling supply and demand, for all values in exchange including wages for labor.

The CHAIRMAN. That is something this committee has nothing to do with; are you going to lead through to a tax system, directly?

Mr. LAPP. Sir, the idea depends on that, somewhat; and I promise you that I will get right to it.

The CHAIRMAN. That is not within our jurisdiction, to deal with that subject matter.

Mr. LAPP. The next paragraph, I think, will show you what I mean, sir.

Two further calamities now threaten us, namely, general sales taxes and 40 billions of new bank credit. Resist these at all costs.

We can straighten out the situation by confining taxes to net income and stop using inflationary bank credit. Taxes should be collected currently as earned. When we expect taxes, taxation is statesmanship.

We can pay fully for war as we go, without bonds and bank credit. Nobody would be ruined by income taxes since cost of production and tax-free subsistence would always be exempted. Taxation spells wisdom.

Although the income tax is relatively recent, it can properly bear the entire burden. The beneficiaries of the regime have the greatest stake in its survival. They should be made to pay outright without

future compensation through bonds. After war, either bonds or prosperity.

This simple program is offered to the Government as a pattern for correct economic behavior. Political expediency will soon demand it.

I will now read to you the detailed memorandum to which I have referred in my introductory statement just given.

Physical supplies and services and men necessary to carry on in peace or in war are provided as we go. There is no putting off to the future the production of the things we actually use up. We pay cash for war, physically.

The problem is, how to pay cash financially. Everyone knows that it would be desirable to collect the taxes and pay immediately for any projects we vote to carry on. That is the realistic way to do for the individual or for the Nation.

Senator CONNALLY. May I ask a question?

Do you seek now to get other money by income taxes, net income?

Mr. LAPP. Yes, sir.

Senator CONNALLY. At what rate?

Mr. LAPP. At what wage rate?

Senator CONNALLY. Yes.

Mr. LAPP. What the rates are after the committee has taken out individual expenses and cost of production for enterprises. We can vote anything up to 100 percent.

Senator CONNALLY. The cost of production for enterprise—by that what do you mean?

Mr. LAPP. The cost of production for goods and services by business enterprises

Senator CONNALLY. You could then take 75 percent of the income, or 80 percent?

Mr. LAPP. Yes, sir; you see, of their net amount—that is, after the cost of production.

Senator CONNALLY. Yes?

Mr. LAPP. You can take anything up to 90 or 95 percent.

Senator CONNALLY. That is the gist of your plan?

Mr. LAPP. Yes, sir; but the reason follows.

Our Congress is given the privilege and responsibility of holding the purse strings. Congress also has the power and the duty to tax to keep something in the purse.

The puzzling question is how to collect taxes in the amounts required to pay currently for an all-out national effort. Most people including legislators are sure it can't be done. The outcome of this analysis is to prove that we can collect enough tax revenue without resorting either to bonds or to inflationary bank credit.

We can't get enough from taxes because we now try to collect in an impossible way.

The major source of taxes, National, State, and local, has always been a levy on savings and property, on transactions, sales, excises, and pay roll. In recent years taxes on net income have properly come to be the largest single item of revenue.

In this analysis it is found that the tax on net incomes only is the practical way to finance the war and to command the entire resources of our country. Following are the reasons for abandoning all forms

of sales, transactions, and property taxes and concentrating our attention on the net income tax.

All forms of sales and transactions taxes we may call sales taxes. A sales tax is a capital levy. It is literally a deduction from working capital taken before the ascertainment of loss or gain and taken from individuals or from enterprises even if they are insolvent or below the subsistence level. Legislators have a well-founded reluctance to the imposition of sales taxes. They should not yield to pressure in the direction of greater sales taxes and they would be able to resist if we can develop a practical taxation principle under which we can collect adequate revenue to command all the men and material that can possibly be devoted to Government activities.

The maximum effort that can be devoted to Government will occur if we have full employment of all people capable of productive work at such hours as to produce maximum product and then allow for each person a minimum for physical subsistence at full operating vigor.

All this can be brought about by the adoption of proper financial arrangements. That is, we must levy all taxes on current net income and we must maintain stable money. These two requirements comprise all the machinery by which we have any exchange relations between individuals and enterprises and Government. With rigidly stable money and with the taxation of net income only we can exact from each in extreme emergency everything above a bare subsistence without ruining anybody nor any business enterprise.

Senator CONNALLY. Mr. Chairman, I wonder if it would be possible for the witness to put the statement in the record?

Mr. LAPP. Gentlemen, I would like to make this statement——

The CHAIRMAN. I asked the witness in the beginning if that were possible.

Mr. LAPP. This is something that is different, and if you get hold of this idea, to whatever extent it is incorporated, the actual program will be helpfully benefited.

Senator CONNALLY. We understand that.

Mr. LAPP. Now, we are faced with a ruinous prospect——

Senator CONNALLY. The reason I made that suggestion is, you have given us the idea.

Mr. LAPP. I am afraid I have not, as yet, sir.

Mr. BARKLEY. You are afraid we do not have the idea?

Mr. LAPP. It has taken me 12 years of intensive study.

Senator CONNALLY. We do not have 12 years to give to it.

Mr. LAPP. I have it here, if you will bear with me.

The CHAIRMAN. If you will shorten it; if you will get down to your direct proposal, so far as the facts are concerned, then you can put in whatever you may wish in the record—you may put the complete statement in the record.

Mr. LAPP. Sir, it is not just in the form that I could pick it out like that. I think, considering the importance of the idea, it is extremely brief; and I would like to really go through it so that your minds could just hit on it in a moment or two.

We are rapidly approaching the time for all-out devotion to national purposes. The thing must be done through definite amounts of stable money by which all values are exchanged and precisely

measured. We have for a dozen years and more in a time of peace suffered a chaotic situation to grow worse because of our failure to establish these two indispensable conditions necessary for a peace or for a war economy.

On the crumbling base of a broken-down peace economy we now find ourselves face to face with the stark reality of carrying a national burden several times as heavy as the peacetime load that broke us down. We are witnessing the onrush of a host of large-scale problems.

It is not fair to charge our congressional committees with the responsibility of financing the war and arm them only with discredited methods. Collecting capital levies from insolvent people and enterprises through sales taxes helps to ruin and extinguish the tax sources even in peacetime and cannot provide adequate revenue for war. Responsible people on our finance committees do not dare to collect an important part of wartime revenue by sales taxes. This fact gives telling evidence of the destructive effects of all these transactions taxes that impede the process of production and exchange, ruin producers, and cause unemployment.

The necessity of selling bonds in an endeavor to entice further amounts from the holders of untapped liquid income indicates again that it is considered inexpedient economically as well as politically to collect the full amount of sales taxes. If we had a method of collecting adequate amounts of income we would not have to resort to giving part of our citizens through loans a creditor hold on the country in its time of peril.

We may collect from current income a maximum of $30,000,000,000 out of a $60,000,000,000 budget. This means we have agreed to forego the purchase of $30,000,000,000 worth of goods and services and let our Government buy that much with our earned money, the equivalent of which we have produced and have not consumed. This is presumably all we can be made to surrender by taxation and induced to contribute as savings by patriotism in return for bonds.

So far we have considered earned money that exists for which value has been delivered. So far we are fairly realistic and do only fractional damage to the lowest fringe of our economy.

But we still have 30 billions to collect from some place for which we shall take a second $30,000,000,000 worth of goods and services. All this after we have contributed all we thought we could. How shall we get this last 30 billions?

As a last resort we go to the credit bank for the deficit. It is a complete failure to finance our projects when we ask the bank to issue to our Treasury some 30 billions of promises to pay money in return for some more bonds. The sad effect of this practice is to inflate the bank-deposit money we use in exchange which raises prices in a time of active trade. The extra prices we all pay makes war costs jump up so the Government buys less with our hard-earned tax money.

The small income is to a large degree taken to pay sales taxes and economic ruin overtakes marginal producers. The terribly destructive results of inflationary credit should make us pause and find a more practical way to finance the war program.

These well-known dangers should scare us into a proper handling of our present threatening situation. We should support and im-

plement our fiscal agencies with an effective mechanism for financing our requirements, completely.

At this point I wish to make two serious proposals which will avoid the bad effects cited above, and provide a complete harness in which we can all pull together to win this war and the peace to follow.

The income tax.—The first proposal is to do away with all burdens to production and exchange in the form of sales taxes, transactions taxes, excise taxes, franchise taxes, tariffs, and pay-roll taxes. Even including taxes on property, they are all really deducted from working funds or capital of the taxpayers without regard to solvency and are taken from producing individuals and enterprises whether they have large or small net earnings. When large taxes are taken from those with no net income and from those actually operating at a loss the effects are particularly harmful to the taxpayer and to the Government or society. I shall try to make this point so clear as to leave no doubt about the facts.

Consider the effects of a general 10-percent sales or transaction tax on three types of producing enterprises:

First, a concern that earns 20 percent on its production cost would have paid 10 percent from its working-capital funds, leaving a net income of 10 percent after taxes on which an income tax of say 20 percent would be levied. Total tax, 12 percent, or 60 percent of its income.

Second, an enterprise whose net before taxes is 10 percent. A sales levy of 10 percent would reduce the net to zero which is equivalent to an income tax of 100 percent of the earned net. This reduces a good concern to the verge of loss.

Third, think of the marginal company having no net income or even operating at a loss. If we levy a 10-percent equivalent tax on the values bought or the cost, we cause such a serious loss as to make the enterprise fail and discharge a thousand employees.

Observe that the effect is equivalent to an income tax graduated, but graduated downward for higher earnings. When the net earnings are zero or negative an income tax would take nothing and save the enterprise, but a sales tax would take its 10-percent toll equivalent to an infinite tax, destroying the business.

The same principle of destructive capital levy applies to the home. Each year we levy this tax. The home owner must have current income to pay the capital levy or he suffers the loss of the home.

Now a full-size dilemma appears. We have destroyed a border-line industry producing the goods of life. As long as it operated, its employees were paying us a certain amount of income tax. By causing its extinction we stop the making of useful things by people who are supporting themselves. We transform its employees from self-supporting productive taxpayers to the status of nonproducing dependency and must now collect additional taxes to keep them from starving.

Such compounded dumbness must be a gift. It is too complete to have been acquired even if we studied special advanced courses in dumbness. Not only do we crush out the struggling victims at the bottom of the economic heap but we let the upper level beneficiaries commensurate with the benefits received. We can never make up by surtaxes, no matter how flagrant, for the damage done to the capital of those economically weak border-line individuals and enterprises

from which we are thoughtlessly taking away their essential equipment and substance. This is a species of economic cannibalism reducing producers who are satisfied to go on serving the community and employing individuals without compensation. We should recognize the social importance of an enterprise that maintains a group of producing individuals who are earning going rates for their labor and services and products delivered although the enterprise as a group is receiving no profit. We pounce upon this most vulnerable type of concern and knock it out with a sales tax although it is taking a bad licking in the form of reduced value of savings devoted to a profitless attempt to serve.

An enterprise employing a thousand people at regular rates devoted to serving the community on a no-profit basis is doing just as effective and far more heroic a job compared to a high-level group not beset by the problem of survival. In fact, the socially most important matter deserving our careful consideration is the survival of these same precarious groups. When they fail they carry people down with them into unemployment and cease making useful products.

Before any tax is levied we should allow a producer to get back the amount he has expended in his efforts to serve the community. The sales tax takes part of his savings or capital devoted to this endeavor.

It is a characteristic of highly productive people and nations that they have managed to save a large part of their income and devote it to the making of productive facilities. It is because of our large capital per capita or per worker and by the use of many horsepower that we have been able to produce such a high standard of living as we enjoy.

Sales taxes are a capital levy and result in a depletion of our capital equipment. Instead of taxing our substance we should take our public funds from the product of our work.

The proper source of revenue is the income tax. A feature of the sales tax that has had too little notice is its cumulative or repeating effect on the several stages of production.

Exchange is to a very minor degree a mechanism for delivering goods and services to a final consumer. Exchange is almost wholly a part of the production process, handling values time and again, with very small increment value per exchange.

In active years like 1928 and 1929 with a total net income and production of about $80,000,000,000 worth, the total volume of trade runs about 1,200 billions, or 15 times as much. This means that the typical transaction consists of buying $14 worth of values to which the enterprise adds $1 worth of further productive operations and sells the new product back to the market for $15.

Another effect of this large ratio of total trade to net product is that each percent of general sales or transactions tax is equivalent to 15 percent tax on net income. This is but another way of stating the fact that sales taxes repeat and accumulate as goods move from stage to stage in their progress toward completion. A general transactions tax of 10 percent would assume to take a fanciful 150 percent of our product.

Unfairness in exchange is caused by taxing transactions and by using in exchange credit money that never was earned by doing any-

thing. These burdens imposed by a deranged tax-hungry regime are themselves the cause of economic derangement and unemployment. The more you trade in such an unfair market the more tribute you pay. The vertical trust is a device to protect productive enterprises against an unfair market by minimizing the volume of money transactions. By the organization of five small sequence enterprises into departments of a large business, buying and selling through an unfair market is replaced by the passing of rising values from one department to the next. The artificial advantages enjoyed by the large company enable it to indulge in uneconomic practices and overorganization. To people unaware of the true nature of the advantage this has all the appearances of monopoly. When we learn the fact that trade really free from restrictions would be the basis for survival of multitude of submarginal producers and individuals we can have full employment. So-called monopolies will find themselves shrinking down to the economically justified size.

Free exchange, domestic free trade, is the basis for tranquility in a thriving economy. We have long suspected this fact. It should now be obvious. The same principle of free fair trade would afford the best approach to an international post-war program.

If we are to devote 60 percent of our national efforts to war, we must take from producers 60 percent of our national income. This may mean that we must take by income taxes a flat 90 percent of our net income after a most meager exemption allowance for mere subsistence. If we will do this and forego all forms of property and exchange taxes, two most stubborn problems will disappear. War profiteering by industry and wage profiteering by labor would cease. Unregulated prices for material and wages for labor would again afford a satisfactory basis for supply and demand.

Profits and wages will be taken almost wholly after cost of production and cost of subsistence are first allowed. An exemption of $500 might buy more without any sales tax deductions than $750 will now buy after all the accumulations of hidden taxes are paid. If we stick to this sternly realistic program of paying as we go from net income, every dollar will continue to buy a dollar's worth of food and a dollar's worth of war material and services as well. If we really desire to stabilize our money let us pay out new dollars through Government purchases to maintain a certain amount, say $400 per capita.

If we will but put our necks into the yoke of this rigid harness, we can pull the maximum possible load, all together. If we dodge around and try to save our precious necks, we may get them broken to a harder yoke.

It is only in time of emergency that we are sufficiently scared to submit ourselves to such a rigorous course. Let us quit our fanciful impractical attempts to support our national efforts by consuming our substance or working facilities and put the burden where it belongs—on the product. Let us ascertain the net income of each person and each enterprise, and add up local taxes, State taxes, and Federal taxes, assessing all net income at the same high flat rate. If the community or the State or the Nation added too much, it would lose producers.

Large profits and high wages and the regular supply and demand as determined by price can function as usual with very few exceptions. It will make little difference what the net income is if we take 90 percent

for the national cause. Even if high incomes are almost wholly contributed in taxes, the motivation to produce will not be absent. We will still seek out the lines of greatest usefulness and greatest safety as shown by areas of high wages and high profits. If we let prices rise, the bottlenecks will stick up like beacons automatically guiding us toward the things most urgently needed.

Let the high earnings be won. There can be great pride and satisfaction in being a tax collector if the rules are fair for everyone. In fact most people are coming to ask for just that chance to show their willingness to help if they are sure that no one can take unfair advantage.

We can pay cash as we go.

This, gentlemen, is quite different than anything put across on economics, after a considerable analysis of conventional procedures; and if we do not presume to pay for more than a third of the bill, the terror of writing up two-thirds of the requirements in bank credit will frighten us out.

The CHAIRMAN. We thank you very much, Mr. Lapp.

Is Mr. Klein in the room?

(No response.)

The CHAIRMAN. He does not seem to be here.

Thank you, again, Mr. Lapp.

I believe there is no other witness on this list who is scheduled to appear today.

The committee will go into executive session.

I will ask the Treasury Department representatives and the staff to remain with us.

(Whereupon, the committee went into executive session.)

REVENUE ACT OF 1942

TUESDAY, JULY 28, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will come to order.

Let us see what witnesses are here this morning.

Mr. William H. May, State Commissioner of Agriculture of Kentucky.

(No response.)

The CHAIRMAN. Mr. Mitchell B. Carroll.

Senator VANDENBERG. Mr. Chairman, before the witness starts I want to put one figure in the record based on an estimate which has been made by the Treasury Department.

The CHAIRMAN. Yes, Senator.

Senator VANDENBERG. Yesterday morning, when Mr. Seidman was testifying I raised the point that millions of people in the country seemed to feel if we cut back all personal incomes to $25,000, that that would be a very simple way of financing the war and that there would be nothing left that we would have to do. I think it is very important that the country should be disabused on that wholly fictitious notion, so I asked the Treasury Department to make an estimate, and this is the result: If every individual income in the United States was cut down to $25,000, and if in addition the present high House rates were then applied to what is left, we would get an increased revenue of $660,000,000, which, according to Mr. Morgenthau's estimates, would pay or war bills for just 4 days and 10 hours.

The CHAIRMAN. Did they give you the figures on how much we would get if we cut down without the applications of these high rates?

Senator VANDENBERG. No; but with everything off, after you have leveled all income up to $25,000 and then leave the high House rates in addition to that in the bill, it would only pay our war bill for 4 days and 10 hours.

The CHAIRMAN. All right, Senator. Thank you for putting it in the record.

Mr. Carroll.

STATEMENT OF MITCHELL B. CARROLL, REPRESENTING THE NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N. Y.

Mr. CARROLL. Mr. Chairman and gentlemen, my name is Mitchell B. Carroll, representing the National Foreign Trade Council, Inc., 26 Beaver Street, New York.

The National Foreign Trade Council represents practically all the American enterprises that are still trying to carry on foreign trade in the face of the obvious difficulties of today, and, as you know, the field is practically limited to Latin America. Therefore, in my remarks I will consider primarily the position of our enterprises in Latin America, and I will direct my remarks to the maintenance of a certain device in the revenue act which was introduced in 1918 as a war measure and has been conserved in the act since that time, in order to place our enterprises more in the position of parity with those of Great Britain, France, Germany, and other countries that were engaged in trade in Latin America in those days. While some of the Axis-controlled companies are blacklisted today, nevertheless their representatives are still there and still trying to harm our trade as much as possible and to prepare for the stiff competition that will inevitably ensue when the war is over.

In 1918, you will perhaps recall, Mr. Chairman, a provision was incorporated in the revenue act to prevent international double taxation. It was realized that if an enterprise doing business in any foreign country and also in the United States had to pay taxes in both countries on the same income, the accumulation of the war levies would be so crushing that it would be almost impossible to continue. Consequently the Senate and the House in those days recognized that the country in which the income was produced should have the priority in taxing income, and that an offset should be allowed for the tax imposed in the foreign country against the tax imposed by the United States. However, that offset has been definitely limited, so that this relief from international double taxation can in nowise reduce the American tax on American income. Nevertheless, if the American rate is higher than the foreign rate the United States collects the difference between the American rate and the foreign rate on the income from abroad.

The legislators in 1918 naturally could not foresee all the trends in the world; they could not foresee, for example, the development of exchange restrictions. You doubtless heard of the difficulties that some of our people, who derive income in Brazil, Colombia, and Chile, particularly, have had in bringing their income back to the United States. As you know, because of the depletion of monetary resources, some of these countries which found themselves paying out more money than they had coming in put restrictions on the paying out of funds. Thus income is blocked. Sometimes it will remain blocked for a year or two or three. Now, if income is blocked it may, under a ruling of the Board of Tax Appeals, preclude the operation of the credit. That is to say, the credit for a foreign tax in Chile paid in 1942 has to be taken in the year when it is paid or accrued, namely, 1942. But if the income of that year is blocked and not released until 1943 or 1944, the operations of these limitations on the credit, which require that you

put into the numerator of limiting fractions the net income from the country, it would obviously preclude any credit because there is no net income brought to the United States. There is nothing to put into the numerator of the limiting fraction; consequently, there is no credit.

Therefore, we are asking that you merely provide in the law that the tax should follow the income, or if income is blocked and is not released until a later year, that the tax on that income can be deferred as a credit until the income is released and brought into the gross income. That is the first of our clarifying amendments.

The second one is intended to take care of a very serious trend in the development of tax legislation, primarily in Latin-American countries. As you have possibly been informed, our income tax is developed to a point of refinement far in excess of the income tax of any country in the world, even in Great Britain. In other words, we have a more exact concept of the nice determination of income than any other country. These countries to the south, which have started imposing income taxes in the last 10 or 15 years, for the most part are inclined to resort to empirical methods of taxation, especially where they are trying to impose a tax on foreign enterprises.

You can imagine yourself in the position of the tax administrator in Cuba, for example, who has there in Habana the branch of an enterprise manufacturing various articles in the United States, and selling them in Cuba. The Cuban tax administrator can easily verify the gross income of that enterprise, but the Cuban tax administrator has no way of verifying the expenses, most of which are incurred in the United States and in transporting the goods to Cuba. So Cuba resorted to a very simple empirical method of taxation. It was first resorted to in connection with shipping enterprises. The Cubans found it almost impossible, just as we did back in 1921, to determine the net income of a foreign shipping enterprise. They could tell how much was collected in the country, but there was always an interminable argument as to how much should be deducted from that income in arriving at net income. So the Cubans arrived at a very simple method of determination. They arbitrarily assumed that the expenses of the enterprise would be equal to about one-half of the gross income, but instead of reducing the gross income by one-half they simply cut the rate applicable to Cuban enterprises, namely, 6 percent to 3 percent, and provided in the income tax law that this rate be applied directly to the gross income of a foreign shipping company.

That worked so well that in 1932 they extended the same solution to apply to merchandising enterprises and communications enterprises. The rates have since changed, but today, where a Cuban corporation is subject to a tax of 10 percent to 20 percent on net income, an American corporation with a branch in Cuba is subject to a tax of 3 percent on the gross. In other words, they assume that the expenses are represented by this reduction in the rate that is applied to gross income. But under the rulings of the Bureau and the various courts it has been held that when a tax is imposed on gross income it is an excise tax and not a tax within the purview of section 131. We are asking that this doubt be removed, that a tax which is clearly imposed in substitution for a tax on net income should, nevertheless, be allowed as a credit.

There are other types of taxes that countries have resorted to when a foreign enterprise is operating in the country. Take the Guatemala tax administrator who is trying to determine the profits tax on fruit raised in Guatemala and sold in New York. The enterprise realizes no income until the sale is made in New York. The Guatemala tax administrator has no way of determining what part of that income is allocable to Guatemala, and in agreement with the enterprise it was stipulated and sanctioned in a special law that instead of paying the ordinary profits tax the enterprise would pay a tax of 1½ cents per stem of bananas, for example. That represented a fair determination of the tax attributable to the income in the country.

The most recent development in this field is in Haiti. The Haitians, as you know, have a background of French culture, and they have copied a French device in the law of May 2, 1942, to determine income on the following bases: First of all, they will determine a minimum income equal to five times the rental value of the premises occupied; then, if there is any profit made in addition to that, or in excess of that, the tax will be imposed on the excess income as well as this minimum basis. That saves the Haitians difficulty in arriving at some net basis for their tax. We are asking that these empirical taxes which are being resorted to be allowed as credit, subject to three conditions: In the first place, there must be an income tax that would be allowable anyway as a credit in the country itself. For example, in Cuba the taxes that I described have been imposed in lieu of a general tax on net income applicable to the enterprise of the country. Secondly, that the empirical tax must be definitely imposed in substitution for that tax. In other words, it must be a short-cut method to facilitate the determination of liability to the tax on net income. Thirdly—and this is the important thing from the viewpoint of the Treasury—that this allowance be made only if the taxpayer determines, in accordance with American concepts, the net income attributable to the country. As you know, we have in section 119 of the act, and the regulations relating to section 119, a clear-cut indication of sources in a foreign country and sources within the United States, so it is quite possible to determine, according to American concepts, the net income attributable to the country and the net income that is effectively subject to this empirical tax.

Senator TAFT. You mean that you can deduct a loss in one country from profits in other places?

Mr. CARROLL. The purport of this is to place the taxpayer in the same position that he would be if the foreign country adopted a pure type of tax on net income and applied it to foreign enterprises. In other words, the income is subjected to double taxation. As long as there is net income in the country it effectively bears this tax, and we are asking that this request be granted only if the taxpayer shows a net income which effectively bears the tax and which will have to go into the numerator of limiting fractions in section 131 (b). The taxpayer, of course, would have to submit all the proof required under section 131 (e).

There is another small point that has arisen. A number of our enterprises that are carrying on long-term contracts in various Latin-American countries were caught when the excess-profits tax was introduced in 1940. In view of the difficulties of determining net income,

these enterprises reported their earnings on a completion basis. Of course, as long as you had merely a normal tax it did not make any difference. There might be some increase in rate but the difference would not be so great, but when the excess-profits tax was introduced in 1940 it caught some enterprises. They were completing contracts in that year and reporting their income in that year on the basis of accounting approved by the Bureau of Internal Revenue, but the income was really attributable proportionately to prior years. Well, the Senate took cognizance of this fact, and in the report of the Senate Finance Committee on H. R. 10413, on page 41, there appears the following statement:

If it is determined that the net income received in the taxable year is attributable to years in the base period, the amount of such income so attributable to such years will have the effect of increasing the base period net income and thus the credit under the average earnings method.

That injunction of the Senate was lost in conference, and in the regulations, section 30.721–3 of regulation 103, there appears the following:

Section 721 has no effect upon the computation of base period net income or of earnings and profits, and therefore does not affect the computation of the excess-profits credit.

Clearly, that leaves some of these interprises in a very unfortunate situation now that our excess-profits-tax rates are going up to terrifically burdensome heights, and we are asking that the Senate resume its consideration of this question and have an amendment put in the act which carries out the intent expressed in 1940. In other words, it is very simple to provide that this income attributable to prior years be included in the base period net income, and then logically one should also make the adjustment that if the earnings have been reported on a completion basis in the base-period years a similar adjustment could be made in those years, so that in each of the years you have the income properly attributable thereto. I think that the idea may be simply expressed in language something like this:

For the purpose of excess-profits credit based on income, the amount of net abnormal income derived under a contract, the performance of which required more than 12 months, which is reported in any taxable year beginning after December 31, 1939, that is determined to be attributable to any taxable year or years in the base period shall be included in the excess-profits net income of such taxable year or years, and the excess-profits net income of each of the taxable years in the base period shall be adjusted so as to include only net income properly attributable to work performed during each of such years.

In other words, contractors who, with the approval of the Bureau, were reporting their income on a completion basis and were caught because of the introduction of the excess-profits tax, will be put in a position as if they had been reporting from year to year the net income attributable to those years.

Senator TAFT. That applies not only to foreign trade but to your domestic contractors?

Mr. CARROLL. That would apply to the domestic as well. The National Foreign Trade Council of course represents only the foreign contractors, but it should apply equally well to the domestic contractors who report on a completion basis.

The CHAIRMAN. Have you discussed these problems with the Treasury?

Mr. CARROLL. Yes; I have, sir.

The CHAIRMAN. All of the problems you have presented to us you have discussed with them?

Mr. CARROLL. Yes; I have, sir.

The CHAIRMAN. I think the Finance Committee in the 1941 act undertook to have the credit that was thrown back used as a basis of increasing the base credit, but the Treasury did not take that view of it.

Mr. CARROLL. I have discussed it with them. Of course, I cannot say what their attitude is, but it was suggested that I present the matter to the committee in any event.

The CHAIRMAN. Have you prepared amendments that would cover the specific point?

Mr. CARROLL. Yes; I have ventured here to draft something, sir, which is attached to my memorandum.

The CHAIRMAN. Have you a memorandum?

Mr. CARROLL. Yes, sir.

Senator WALSH. I suppose the interpretation put on this matter by the Treasury Department would preclude a favorable opinion, and that is why you are submitting it to the Finance Committee?

Mr. CARROLL. Well, it was at the suggestion of a Treasury official that I am doing it, sir. I think you will find them sympathetic to the change. I cannot speak for them, naturally. I think it is now recognized, in view of the exceedingly high excess-profits tax, that it is only fair to make this adjustment.

Senator WALSH. I suggest, Mr. Chairman, that these changes be submitted to the Treasury Department.

The CHAIRMAN. Yes.

Senator TAFT. Mr. Carroll, may I ask you, do you have any views on the repeal of section 116 (a)?

Mr. CARROLL. Yes; I could say much against its repeal in the case of citizens who are bona fide residents of a foreign country, but there are gentlemen coming up from Habana, Cuba, and other places that can give you first-hand information from those centers of American commerce abroad.

Senator TAFT. That point will be presented to us?

Mr. CARROLL. Yes. I believe it is scheduled for the 4th of August, sir.

The CHAIRMAN. Yes; we have witnesses on that question. They have already asked to be heard, and they have already been given assurance that they would be heard.

Are there any further questions from Mr. Carroll by members of the committee?

If not, we thank you very much, Mr. Carroll.

Mr. CARROLL. Thank you, Mr. Chairman.

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

MEMORANDUM OF MITCHELL B. CARROLL, REPRESENTING THE NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N. Y.

PROPOSED AMENDMENTS TO SECTION 131 I. R. C.

Mr. Chairman, gentlemen: In behalf of the members of the National Foreign Trade Council, Inc., I beg to submit some clarifying amendments to section 131 of the Internal Revenue Code which are intended to help conserve sources of income abroad, such as business establishments in Latin American countries, and encourage the flow to the United States of income from those sources. Such establishments are of vital importance in enabling the United States to maintain

its position in the markets of Latin America and other friendly countries, so as to be prepared after the war to get its full share of business in the face of intense competition of foreign enterprises which are at present enemies, as well as of enterprises of allied countries. The amendments are necessary to conserve the sources because if income from American establishments in other countries is subject to taxation both abroad and at home, the cumulative burden would be so great as to destroy the incentive for carrying the risks incident to foreign commerce and result in the abandoning of the establishments.

If section 131 is permitted to operate as intended, the domestic company will pay as much tax as if it operated only in the United States, but an obstacle will be removed to bringing home income and paying it out here for raw materials and supplies, or for salaries and wages, or as dividends. The wealth of the country is thereby increased and the basis for taxation broadened. The accomplishing of this objective would be facilitated by these amendments which tend to counteract the technically inescapable effect of exchange restrictions on tax liability and certain trends in foreign tax legislation which were not foreseen when Congress adopted in the Revenue Act of 1918 a measure to help our enterprises face the difficult circumstances arising out of the previous World War.

The basic reason for said measure was that, if our enterprises were to continue to compete abroad with foreign companies which were receiving tax exemptions and other kinds of aid from their respective governments, it would at least be necessary to allow a credit against the United States income tax for income taxes paid in foreign countries. The credit has justifiably been limited so that in no case may the offset reduce the United States tax on domestic income and, where the foreign rate is lower than the American rate, our Government collects the difference in rates on the foreign income.

An increasing number of countries have in recent years undertaken to arrest the depletion of their national monetary resources by adopting exchange restrictions, with the result that, in many cases, income which has been earned abroad by American enterprises is blocked and cannot be utilized. The question has arisen whether such income, which cannot actually be enjoyed by the American enterprise, should be treated as income for tax purposes here, and the Board of Tax Appeals has ruled that such blocked income need not be treated as income until it is unblocked or becomes convertible into dollars (*International Mortgage and Investment Corporation* v. *Commissioner*, 36 B. T. A. 187). However, the foreign tax on such income may be taken as a credit only in the year when said tax is paid or accrued and, if this unblocking takes place in a later year, there will probably be no income to place in the numerator of the limiting fractions in section 131 (b) and, consequently, no credit will be allowed for the tax paid abroad on such income.

Hence, we respectfully urge you to remove this unintended inequity by adopting our proposed amendment which, in substance, would treat the tax as following the income and would allow it to be taken as a credit in the taxable year when the income in question is brought into gross income.

This amendment presupposes that the Bureau will continue to apply liberally the Board decision mentioned above with regard to foreign income that is technically blocked.

The United States has undertaken to prevent international double taxation of income by the allowance of a credit for foreign income taxes, but the term "income taxes" in our law has been so narrowly construed as to preclude the credit for what Latin Americans consider to be income taxes. This is due primarily to the fact that, in this country, the concept of income tax has been developed to a very high point of refinement whereas, in numerous countries, the concept of income and of a tax on income is more elementary. Nevertheless, the latter type levy reduces just as effectively net income from sources in the foreign country. When such income is derived by American enterprises, it is subject to double taxation which the credit was designed to avoid. However, numerous decisions reflecting our advanced concept of an income tax have disallowed these foreign taxes as credits.

Such a disallowance might take place when a tax of the character of an income tax is imposed upon a base developed from gross income. For example, to obviate the difficulty in verifying deductions which may reduce gross income by one-half, Cuban law provides for levying in lieu of a tax of 6 percent on the net income which is applied in the case of domestic shipping companies, a tax of 3 percent on the gross incomes of foreign companies. Similarly, the same law which imposes a tax progressing from 10 to 20 percent on the net income of Cuban merchandising or communications companies, provides for subjecting foreign companies engaged in such business to a tax of 3 percent on gross income.

The credit might be denied when, to facilitate the imposition of income taxes on companies, the laws or decrees of the country prescribe a shortcut or empirical method of computing liability to the income tax, such as by multiplying each unit produced by the presumed net profit attributable thereto. In other cases a reduced rate is applied to the total number of units.

Perhaps the most recent example of an empirical method of determining tax liability is found in the Haitian income tax law of May 2, 1942, which imposes a tax with rates progressing from 3 to 15 percent on the basis of (1) a fixed income equal to five times the rental value of all the buildings and properties occupied by the taxpayer plus (2) the net profit, if any, in excess of the fixed amount described under (1). In other words, the taxpayer is arbitrarily assumed to have a net income equal to five times the rental value of the premises, which results in a minimum tax. This levy is modeled after the French law which provides for taxing foreigners residing in France on the basis of a presumed net income equal to five times the rental value of the dwelling place, unless they derive more income from French sources.

Although the determination of liability to the income tax by such methods is different from our own, this raises no insuperable difficulty to making a proper allowance under the credit provision. In numerous cases, if the corporation were to pay the ordinary tax on its net income attributable to the foreign country, the tax would be higher than the amount it pays on the special basis adopted. Nevertheless, the tax on net income under the ordinary rates would be granted a credit whereas the tax on the special basis which is intended to be the equivalent of the former would be disallowed.

As the limitations in the credit provisions require the determination of a net income attributable to the foreign country verified in accordance with our own concepts, and would in any event preclude the allowance for the foreign tax from reducing the United States tax on domestic income, we respectfully urge the adoption of an amendment containing a definition which will permit of a more liberal and realistic interpretation of the term "income tax" and thereby enable section 131 to operate more effectively.

More specifically we urge that—

(1) When a foreign country imposes an income tax that would be allowable as a credit under section 131, and

(2) Resorts to an empirical tax on gross income or on some other basis to obviate the difficulty of determining net income, that

(3) The credit shall be allowed for such empirical tax provided the taxpayer proves to the satisfaction of the Commissioner of Internal Revenue the amount of net income actually allocable to sources in the foreign country in accordance with the requirements already set forth in subsections (b) and (c) of section 131.

I beg leave to submit herewith a detailed discussion of these proposed amendments, and if it is considered opportune, I would appreciate receiving your permission to discuss the details with your technical staff.

Proposed amendment No. 1

To allow credit for foreign taxes on blocked income until release of income

The decision in the case of *International Mortgage and Investment Corporation* v. *Commissioner* (36 B. T. A. 187), to which the Commissioner has given his acquiescence, 1937-2CB15, permits the carrying forward for tax purposes of completely blocked income until it is released; and if this interpretation of the law is generally applied, it may result in the loss of the credit for foreign taxes in a growing number of cases. The credit for foreign taxes on blocked income may be assured, however, by a simple amendment which merely states a principle inherent in section 131 of the Internal Revenue Code.

In the above-mentioned case the petitioner realized gain by purchasing at less than their face value mortgages which were paid off at their full value. The Board of Tax Appeals observed that, measured in marks, the petitioner had income from its business in Germany, but that income for our Federal income-tax purposes is measured only in terms of dollars. The marks received after a certain date were blocked and they could not therefore be removed from Germany either physically or by way of a credit during the remainder of the taxable year, nor could the dollar equivalent of the marks be obtained. The petitioner did not have unrestricted use and enjoyment of the marks, and could not use them to retire its bonds as planned. It could not have any of these marks released until a number of years later. The marks were seriously restricted and in no sense the

equivalent of free marks. The Board therefore held it was improper to compute a gain to the petitioner from the repayment of the mortgages by translating the gain in marks received into dollars at the rate of exchange applicable to free marks.

However, the Board held that taxable gain had been realized in marks which were received previous to the time of the imposition of the exchange restriction and because these earlier funds had been freely negotiable, convertible, and transferable. They could have been removed from Germany when received but had been allowed to remain there until they were blocked.

There may be a great many situations in which an American taxpayer will receive foreign currency income in the forms of dividends, interest, royalties, trading profits, or otherwise, which is blocked, and only in a later year susceptible of conversion or of realization through use.

Although the International Mortgage & Investment Corporation decision involved only a very limited class of income, its basic reasoning may well apply in determining what shall be included in gross income in many other blocked currency situations. It would be very difficult to draft legislation to cover the facts of all these situations, and perhaps it may be best to leave to determination in audit whether, under the facts of each case, blocked foreign income should be regarded as realized in terms of dollars and included in gross income, or should be regarded as not realized until a later year. In the former case the amount of foreign taxes thereon would be converted into dollars at the same rate and taken as a credit under section 131. However, if foreign income were not included in gross income until a year or more after it arises abroad, then any foreign income taxes paid or accrued with respect to such income should be carried forward for the purposes of the credit for foreign taxes in section 131 until the foreign income is included in gross income.

Only such a procedure would be consistent with the underlying principle of the foreign tax credit. The law presupposes that foreign income will be subjected to the United States tax for the year in which it is realized and, under section 131 (a), only taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States may be taken as a credit. Furthermore, under section 131 (b) (1), the credit for the taxes of any particular foreign country may not exceed the same proportion of the United States tax against which it is taken, which the income from such country bears to the entire net income, in the case of a taxpayer other than a corporation, or to the normal-tax net income, in the case of a corporation, for the same taxable year.

Strictly speaking, therefore, under the language of subsection (a), the foreign tax paid on blocked income can be credited only in the taxable year in which it is paid or accrued. If the taxpayer regularly takes credit on the accrual basis, and if the blocked income involved is not brought into gross income in the given year, no credit would be allowed in that year because the numerator of the limiting fraction would be zero. Situations might also arise where taxpayers could not take credit for the foreign tax on a paid basis for similar reasons. Furthermore, when, in a subsequent year the funds are freed for conversion into dollars or utilization, they would be subjected to the United States tax but ordinarily no credit could be taken against the United States tax for the foreign tax which was paid or accrued during an earlier taxable year. Hence, in such cases the income would be doubly taxed and the purpose of the credit for foreign taxes would be frustrated.

The original intent of section 131 could be realized if the section were amended so as to incorporate specifically the principle that the foreign tax on such blocked income would not be deemed to have been paid or accrued until the taxable year when the income is included in gross income.

This could be accomplished by adding as a new subsection to section 131 the following:

( ) DEFERRED INCOME.—*If, during any taxable year, income arises from sources in any foreign country or any possession of the United States which is not included in gross income under this chapter until a later taxable year, then any income, war-profits, or excess-profits taxes paid or accrued to such country or possession upon or with respect to such income shall be deemed to have been paid or accrued during the taxable year when the income upon or with respect to which they are imposed is included in gross income for purposes of the tax imposed by this chapter.*

The corresponding amendment to section 23 is printed in italics below:

(c) (1) (C) income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States; but this deduction shall be allowed in the case of a taxpayer who does not signify in his return his desire to have to any extent the benefits of section 131 (relating to credit for taxes of foreign countries and possessions of the United States): *Provided, That, if during any taxable year income arises from sources in any such country or possession which is not included in gross income under this chapter until a later taxable year, then any such taxes imposed upon or with respect to such income shall be deemed to have been paid or accrued during the taxable year when the income upon or with respect to which they are imposed is included in gross income for purposes of the tax imposed by this chapter.*

Proposed amendment No. 2

To allow a credit for foreign taxes imposed in substitution of income taxes which are allowable as credits

Although domestic corporations are allowed a certain credit for income taxes paid to a foreign country, the credit has been disallowed in various cases where, under the law imposing the income tax or a law or decree relating thereto, tax is levied on the basis of gross income to obviate difficulties in computing the tax on net income. In other words, even though the tax on the latter basis is paid in satisfaction of liability to the tax on net income, the corporation is denied the relief from international double taxation provided in revenue legislation since 1918. This relief is of vital importance today as the piling of the crushing United States rates on top of foreign rates might result in a tax burden which would even exceed the amount of the income from abroad. Empirical levies of this kind have been resorted to in practice by the United States, and in practice if not with legislative sanction by Great Britain and all the leading countries of the world, to facilitate the taxation of foreign enterprises producing abroad and selling in the taxing country or producing in the taxing country and selling abroad.[1]

Moreover, the income-tax laws or decrees of various Latin-American countries provide for taxation on an arbitrary basis in lieu of the tax on net income. As the foreign commerce of our private enterprises is now virtually limited to the Western Hemisphere and is further limited by priorities and restrictions necessitated by the war effort, the assurance of the full relief from multiple taxation intended by Congress is all the more vitally important to the American corporations that are still in a position to carry on business abroad.

The United States has taken the lead in providing for the scientific taxation of international business by prescribing in its law and regulations principles and methods for determining income allocable to sources within and without its territory (sec. 119 I. R. C.; art. 19.119–1, et seq., reg. 103). Nevertheless, in computing the income taxable in the United States in the case of a foreign corporation producing or manufacturing abroad and selling in this country, the Bureau of Internal Revenue has encountered such difficulty in verifying the expenses deductible from the gross income realized on sales here, that it has applied to such income a percentage representing the average ratio of net income to gross realized by similar domestic enterprises. The tax at ordinary rates is then imposed on the net income so computed.

Furthermore, the Bureau of Internal Revenue has held that the tax imposed by the Brazilian income-tax law upon the income of a corporation computed by an optional method, consisting of applying coefficients (established by a technical committee) to gross receipts to arrive at "net income," was an income tax allowable as a credit under section 238 of the Revenue Act of 1926 (G. C. M. 803, V-2CB75).

The foregoing procedure involves the application of the ordinary income-tax rates to the empirically determined "net income." Cuba, however, took a short cut in computing tax liability by taking for granted that in the case of shipping enterprises allowable deductions ordinarily consume one-half of the gross income, and consequently provided in the general tax law for a tax at one-half the ordinary rate which is imposed directly on the gross income of the foreign corporation from defined Cuban sources. Thus, while national shipping companies are subject to a tax of 6 percent on their net profit, the law provides that

[1] League of Nations, Taxation of Foreign and National Enterprises, vol. IV, p. 54 et seq.

foreign shipping companies which are engaged in transporting freight and passengers between national and foreign ports shall be exempt from the tax on profits and shall in lieu thereof pay a tax of 3 percent of the gross income obtained for freight and passengers which they may ship in national ports. (Act III of Military Order No. 436 of 1900, as amended by Act XV, the law of July 6, 1928.) The tax imposed on this basis was held to be allowable as a credit in a decision of the Board of Tax Appeals promulgated May 6, 1942, in *Seatrain Lines, Inc.*, v. *Commissioner*, 46 B. T. A. 145, but the nonacquiescence of the Commissioner is possible.

This short-cut method of satisfying liability to income tax was found to be so practical that in 1932 Cuba applied it to other types of enterprises under a provision now found in article II (f) of Decree No. 1117 of May 15, 1939 (Official Gazette No. 352 of May 31, 1939), modifying the regulations governing the profits-tax law.[2]

Accordingly, American corporations are subject to a tax of 3 percent on gross income in place of the tax on net incomes paid by Cuban corporations which progresses from 10 percent on net income nor exceeding $100,000 up to 20 percent on the excess over $1,000,000.

This tax is authorized for three categories of foreign corporations:

(1) Those which sell their goods through branches, subsidiaries, or agents in Cuba. For such a company there are certain qualifications about applying this tax when the company is not able to present evidence justifying lack of profits but it is understood that this levy is applied generally as a minimum tax.

(2) Those which compensate their Cuban representatives by a percentage of the income obtained in Cuban territory for the sale, lease, exhibition, etc., of transmitted articles; and

(3) Those operating radiotelegraphic, cablegraphic, and radiotelephonic systems.

It is to be noted that the 3 percent tax is applicable without qualification to the gross income of the last two categories of companies. A provision for imposing such a tax on gross income in lieu of the tax on earnings has been incorporated in a decree confirming a concession agreement between the Cuban Government and an American company operating a telephone system in Habana.

With regard to shipping companies, the Board of Tax Appeals in the case of Seatrain Lines, Inc., recognized that: "The 3 percent by which the original 6 percent rate was reduced was apparently an approximation of the deductions allowed in arriving at net income and was adopted as a compromise measure in order to avoid the complex and vexatious allocation and calculation of the deductible items peculiar to the petitioner's business. Therefore, it appears that as to the petitioner's business the present 3 percent tax is but the successor of the 6 percent income tax, took its place in the tax structure of Cuba, and preserved its character as an income tax."

The foregoing lucid explanation applies equally well to the application of the 3 percent rate in the case of foreign merchandising and communications enterprises.

The Board proceeds to point out that in this country taxes imposed on gross income have been held to be income taxes, such as certain taxes imposed on the wages of individuals by section 1400 of chapter 9 (entitled "Employment taxes"), Internal Revenue Code, and the taxes paid by individuals under Form 1040A, based on a gross income of $3,000 and less. The Board might have added that the Federal income tax which is ordinarily imposed on net income is levied on the gross income from specified sources in the United States derived by nonresident aliens and foreign corporations not engaged in trade or business nor having an office or a place of business in the United States (secs. 211 (a) (1) (A) and 231 (a) (1), I. R. C.).

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[2] A translation of this article prepared by the American Chamber of Commerce of Cuba reads as follows: "(f) A tax of 3 percent on gross incomes (in place of the tax on profits) shall be paid by all foreign companies operating in Cuba through branches, subsidiaries, legal representatives, or agents, which fix by contract, or any other means, the cost and sales price of the merchandise in which they trade and which are unable to present satisfactory proof of prices and evidence to the Government that the lack of profits is not due to price manipulations; and when they have contracted with foreign companies to receive a percentage of the income obtained in Cuban territory for the sale, lease, exhibition, etc., of transmitted articles; even when the companies are Cuban companies.

"Also subject to these provisions are radiotelegraphic, cablegraphic, and radiotelephonic companies."

The Board cites Treasury decisions holding that certain foreign taxes imposed on gross income are allowable as credits under section 131 I. R. C., including Canadian dividend taxes, Canadian copyright taxes, French rental value taxes, and Argentine dividend taxes, as well as a French tax based on an income presumed to be equal to seven times (later five times) the rental value of the dwelling occupied (*Herbert Ide Keen*, 15 B. T. A. 1243), and certain Cuban taxes (*Havana Electric Railway Light & Power Co.*, 34 B. T. A. 782).

Naturally, the allowance of the credit for such taxes is subject to the limitations under subsection (b) requiring the determination of the "net income" from sources in the foreign country, and to the submission of evidence of the income derived from the country in accordance with subsection (e), of section 131.

As such provisions absolutely limit the credit to the tax effectively imposed on the net income allocable to the foreign country; and preclude any reduction in the United States tax on income from sources in this country, there should be no reason to hesitate to adopt a clarifying amendment which would assure domestic corporations the protection against international double taxation which is intended by section 131, I. R. C.

The allowance of the credit is equally justified where the tax on net income is replaced by a tax imposed on an empirical basis in the base of foreign enterprises which produce or process goods in the country and sell them abroad. For example, when an American enterprise produces a certain raw material in a Latin-American country and sells it in the United States, obviously the local authorities (who have no jurisdiction over the place of sale) may find it difficult to determine the part of the net income realized at the place and time of sale abroad which is attributable to sources in their territory. If world-market prices exist for the product as of the time it leaves the country a local profit may be measured by assuming a sale was made at that price, but in other cases some form of empirical determination may have to be employed.

For example, Guatemala subjects foreign and domestic corporations to an income tax. The tax was originally imposed at the rate of 5 percent by act 17 of Decree No. 1543 of June 26, 1934.

Act 27 of the same decree exempts from this tax companies which have their taxes fixed by contract or law.

To simplify the determination of the profits tax, an American company which produces agricultural commodities in Guatemala and sells them in the United States agreed to pay to the Government of Guatemala, in addition to certain other levies, a profits tax (impuesto de utilidades) of 1½ cents per unit exported by it from the Republic (Law No. 1499 enacted by the Legislative Assembly of Guatemala on May 4, 1927, as amended by Law No. 2138 of 1930).

In view of the fact the company paid this special tax on profits, it was specifically exempted from the general income tax under Decree No. 1543 by an official communication from the Secretariat of Finance and Public Credit, No. 12416, of August 6, 1934.

Other empirical methods are frequently adopted with a view to obviating disputes as to the actual amount of profit attributable to production or processing with the taxing country. Tax administrators in practice as well as under the provisions of tax laws, decrees, and regulations have predetermined an average or arbitrary figure representing net profit per unit of product for specific industries and have applied this to said units (such as barrels or tons of oil processed, standard bags of coffee, sugar, etc.) in computing the base for the application of the income-tax rate. Such situations are a short cut to computing a tax in lieu of the tax on orthodox net income or the arbitrary fixing of the taxable net income itself.

There is no inherent difference in the various methods of determining tax liability cited, except that some involve only one computation whereas others involve two or more. The result is the same—a reasonably fair approximation of what the tax would be if computed at regular rates upon the net income attributable to activities within the country.

In all cases cited the following conditions are met:

1. There exists a general law imposing an income tax which would be allowable as a credit under section 131.

2. The empirical tax in question is specifically levied, under the same law or a decree relating to the general income-tax law, in lieu of the tax generally applicable.

3. To obtain the credit for the foreign tax under section 131 the taxpayer would have to determine the net income allocable to the foreign country in order to meet the requirements of subsections (b) and (e) of said section.

A draft of amendment to section 131 which would allow the credit when such requirements are met follows:

Draft amendment No. 2

SEC. 131 ( ). For the purposes of this section, the term "income, war-profits, and excess-profits taxes" shall include a tax imposed on gross income or on some other basis which is levied in subtitution for a tax on net income allowable as a credit under this section, provided the taxpayer proves to the satisfaction of the Commissioner the amount of net income allocable to sources within the foreign country in accordance with the requirements of subsections (b) and (e) of this section.

JULY 24, 1942.

ADDITIONAL MEMORANDUM OF MITCHELL B. CARROLL, REPRESENTING THE NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N. Y.

PROPOSED AMENDMENT TO SECTION 721 I. R. C.

To permit, in the case of long-term contracts envisaged in section 721 (b), an adjustment of base period net income on the basis of actual earnings attributable to each year

In behalf of members of the council engaged in construction work in Latin America under long-term contracts, I wish to bring to your attention an application of the excess-profits tax which is contrary to the intent expressed by the Senate when it introduced section 721 in the Second Revenue Act of 1940 and which will result in a crushing burden of taxation for the enterprises in question, especially if the contemplated rates are to be imposed.

Because of the uncertainties in the costs of performing contracts involving operations over 1 year, and sometimes as many as 3 or 4 years, it has been customary for the contracting firm to determine the net income at the time of completion and to include it in the taxable income of that year. Recognizing that a serious hardship would result if all of such income were subjected to the excess-profits tax for the year of completion when it was grossly disproportionate to the amounts of such income received by the taxpayer in the 4 previous taxable years in the course of which the income was actually earned, the Senate envisaged the determination of the amount of such income attributable to any previous taxable year or years, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. The paragraph in the report of the Senate Finance Committee on H. R. 10413, at page 41, concluded with the following statement:

"If it is determined that the net income received in the taxable year is attributable to years in the base period, the amount of such income so attributable to such years will have the effect of increasing the base period net income and thus the credit under the average-earnings method."

However, section 30.721-3 of Regulation 103 states that:

"Section 721 has no effect upon the computation of base period net income or of earnings and profits and therefore does not affect the computation of the excess-profits credit."

Obviously, income properly attributable to years in the base period should be included in the net income of those years in order to arrive at the credit under the average-earnings method. This is especially true if, during these years, earnings were abnormally low or if not losses were suffered. If net income was reported in any of the base years on a completion basis, the part attributable to other base years or prior years should, of course, be apportioned thereto.

If such a correction is not made, the credit will not fairly reflect the real average earnings of the base period, and the taxpayer's income which bears the excess-profits tax will be unduly increased. If the proposed rates are then imposed on the mathematically increased income, the resulting burden on the taxpayer will be relatively heavier than that imposed on taxpayers who were in a position to keep their accounts on an annual basis.

The inequity of the law as it now stands may be shown by example. Let us assume that a construction contractor received a contract on January 1,

1938, which would take 3 years or more to complete, the work being done in South America and being actually completed in 1940; that this contract amounted to $2,000,000 and showed a profit of 15 percent or $300,000 and that the contractor, because of the impossibility of accurately determining profits until the work was completed had elected to file his tax reports on the completed contract basis. That this same contractor, through operations on both long- and short-term contracts during 1938, 1939, and 1940, did not make enough profit to show any taxable income in 1938 or 1939, but in 1940 he showed as taxable income the $300,000 made largely on a long-term contract. That the character of the work on the long-term contract was such that the work progressed in an orderly manner, one-third of the work being completed in 1938, one-third in 1939, and the balance in 1940 ,and that the payments received by the contractor were more or less equally divided over these 3 years.

Such a contractor would, under section 721, be able to apportion his income to the years in which the work was done, and if by so doing he had a taxable income, subject to the excess-profits tax in 1940, paying the 1940 rate only on the proportion of the profit attributable to that year. However, under the present law, if in 1942, the contractor completed a number of contracts which showed a total taxable profit of $300,000 the credit allowed him would be calculated on earnings during the base years which might show as follows:

1936	$200,000	1938	Deficit
1937	300,000	1939	Deficit

This, in spite of the fact that his real earnings during the base period, calculated on the percentage of completion basis might be as follows:

1936	$200,000	1938	$100,000
1937	300,000	1939	100,000

It seems manifestly unfair because of bookkeeping methods followed by the contractor, in accordance with the law which gave him the right to report on completion basis, to refuse him the right to show his real income on the percentage of completion basis, as unless he is permitted to do this, his credit to be applied to excess-profits tax is not based on his actual earnings but on a bookkeeping system, which does not properly represent actual earnings.

The suggested amendment should at least cover income received under contracts performed entirely outside the United States, especially in view of the fact that Congress has recognized the desirability of encouraging foreign trade by providing that domestic business corporations deriving 95 percent of their gross income from sources outside the United States are exempt from the excess-profits tax (sec. 757 (g), I. R. C.

Proposed amendment to section 721, Internal Revenue Code

SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.—

* * * * * * *

(b) Amount attributable to other years.

(2) For the purpose of the excess-profits credit based on income, the amount of net abnormal income derived under a contract, the performance of which required more than 12 months, which is reported in any taxable year beginning after December 31, 1939, that is determined to be attributable to any taxable year or years in the base period shall be included in the excess-profits net income of such taxable year or years, and the excess-profits net income of each of the taxable years in the base period shall be adjusted so as to include only net income properly attributable to work performed during each of such years.

To implement the foregoing, the following might be added:

Where the taxpayer has kept its books and filed its income-tax returns in accordance with a completed contract method of accounting during any or all of the base period years, the taxpayer shall, for the purposes of this subsection, determine its average base period net income on the basis of the percentage of completion method of accounting, reflecting work actually performed during each of the base period years.

The CHAIRMAN. Mr. Byrne.

STATEMENT OF DAVID M. BROUDY, NEW YORK, N. Y., REPRESENTING THE BEAUTY AND BARBER SUPPLY INSTITUTE, INC.

Mr. BROUDY. Mr. Chairman, I shall appear for both Mr. Byrne and Mr. Schlesinger, whose name follows his, on behalf of the Beauty and Barber Supply Institute.

The CHAIRMAN. Is this Mr. Schlesinger?

Mr. BROUDY. I am David M. Broudy, of the office of Mr. Schlesinger, 17 East Forty-second Street, New York, counsel for the Beauty and Barber Supply Institute.

The CHAIRMAN. You appear for both Mr. Byrne and Mr. Schlessinger?

Mr. BROUDY. Yes. The Beauty and Barber Supply Institute is a trade association of some 500 dealers who supply beauty and barber supplies and equipment to beauty shops and barber shops throughout the United States.

Now, I should like to discuss the retailers' tax, excise tax, on toilet preparations contained in the Internal Revenue Code, sections 2402 (a) and 2402 (b).

The CHAIRMAN. Did the House bill deal with this matter?

Mr. BROUDY. It did, sir; and a brief submitted by counsel for the institute was considered by the committee and the contentions of the institute were rejected. However, I should like to present the objections to the existing law and a suggested change that is different from the contentions raised before the House Ways and Means Committee.

Now, in the first place, section 2402 provides for a tax imposed upon certain toilet articles, and under the regulations the tax attaches to the sale by the retailer of any preparation which is used or applied or intended to be used or applied for toilet purposes or used in connection with the bath or care of the body, or applied to the clothing, as a perfume to the body, as a toilet article.

Now, section 2402 (b) treats the dealer who supplies beauty and barber shops in quite a different fashion from the wholesaler supplier to drug stores, department stores, and cosmetic stores, and this notwithstanding the fact that the sale performs the same economic function. The difference is that the beauty shop, when it purchases from the wholesaler supplier, does not pay any tax whatsoever on the articles sold except as charged by the wholesale dealer. That is to say, the wholesale dealer is charged with the duty of paying the tax to the Government and the wholesale dealer passes this tax on to the beauty shop.

However, the commodities purchased by the beauty shop are of two sorts: Those purchased for use in the shop and those purchased for resale. In recent years the beauty shop has more and more gone into the business of reselling merchandise purchased from wholesale distributors. In this connection the beauty shop is in competition with the drug store. Inasmuch as the drug store under the act need not pay the tax until it is actually sold, because the drug store is a retailer and under the act the wholesale distributor is considered a retailer, there is an unfair advantage in favor of the drug store and also in favor of the wholesale distributor who distributes to the drug store.

Now, the beauty shops and barber shops throughout the United States employ some 750,000 people. There are some 85,000 beauty shops and 120,000 barber shops employing an average of 3 employees per shop. There are 4,200 combined beauty and barber shops averaging 8 employees, making a total of employees of some 750,000 people.

Now, as is well known, the beauty shops operate on a very small margin and part of their revenue has been gotten from the resale of these commodities, and so with the threatened unemployment through out the country the welfare of these shops is at stake.

The Beauty and Barber Supply Institute is very much interested in seeing to it that these beauty shops continue in business, and if they are forced to discontinue business, of course, it will be a very definite hardship to the dealers whom I represent.

There has been a discrimination in that the dealer must pay his tax, and consequently the beauty shop must pay the tax on the articles for resale before they actually sell them, whereas the drug store does not have to do that. It is this disadvantage as against the beauty shop which I should like to suggest be eliminated by a change in the existing law.

Now, that could be done by segregating the items which are sold for use and those items which are sold for resale. Now, the items which are sold for use are in a very different form from those sold for resale. In other words, those sold for use are in the so-called professional sizes and they are easily differentiated from those sold for resale. So when the beauty-shop supplier, the wholesaler sells these articles he could easily separate those sold for use and those sold for resale, and the tax would be payable immediately in respect to those sold for use in the beauty shop, whereas it would not be payable in respect to those sold for resale until actually sold by the beauty shop.

Senator BROWN. Your objection is that in one case the beauty shop is the consumer and in the other case it is the retailer?

Mr. BROUDY. That is right. Under the act the wholesale supplier is designated a retailer.

Now, on those articles which are sold at retail and upon which a tax has been paid under the act, the beauty-shop owner is permitted to obtain a credit for the tax already paid, but, of course, that entails the making out of two separate returns, and it is very difficult for a small businessman, such as a beauty-shop owner, to calculate and to make the separate returns. The method of computation is rather intricate, insofar as he is concerned.

Now, if I might say parenthetically, the beauty-shop owner, notwithstanding the fact he has made no sale whatever, must, nonetheless, make a return each month, whether he resold any items or not. Under Regulation 51, section 320.60, it is provided the return must be forwarded to the collector for each month whether or not any liability has been incurred for that month.

The argument has been made that if the tax continues as it has, namely, as against the wholesale supplier in all instances, there will be fewer returns. Well, that is not so, because a beauty-shop dealer has been and still is making those returns.

Senator CLARK. I understand that under the present law the distributor to beauty shops or barber shops is considered a retailer, but the distributor to the drug stores is considered a wholesaler.

Mr. BROUDY. That is right, sir.

Senator CLARK. That is the gist of your complaint?

Mr. BROUDY. That is it exactly, bringing on an unfair advantage.

Senator WALSH. As a matter of fact, does the beauty shop or barber shop have to pay more by reason of the taxes being paid at the source than the drug store, for the same articles?

Mr. BROUDY. No; as a matter of fact the beauty shop, because he buys in professional sizes and larger quantities, pays proportionately less for the same quantity.

Senator WALSH. For what he resells does he pay more?

Mr. BROUDY. For what he resells there is a larger tax, which is comparable to the drug-store tax.

Senator CLARK. But the goods sold by the beauty shop or the barber shop pays the same tax that the drug store pays? It is simply a matter of the responsibility of paying the tax?

Mr. BROUDY. It is not only that, but the beauty shop owner must pay his tax when he purchases.

Senator CLARK. In advance?

Mr. BROUDY. In advance, regardless of when he sells. Even if he never sells he must pay that tax.

Senator WALSH. To the wholesaler or to the Government?

Mr. BROUDY. To the wholesaler, who in turn is responsible for the tax to the Government.

Senator WALSH. The wholesaler does not have to pay the tax in advance?

Mr. BROUDY. No, he does not; only when he sells to the consumer.

Senator WALSH. As a matter of practice, is the tax added to the price of the goods that the beauty shop or the barber shop gets?

Mr. BROUDY. Yes; as a matter of fact it is.

Senator WALSH. And it is not charged to the drug store?

Mr. BROUDY. No. Now, there is another phase of this problem which has arisen as a matter of practice. Because of the fact that the wholesale distributor is a retailer the beauty shop owner in recent months has been manufacturing his own preparations and using them in his shop for application in treatments. Now, there is no tax obtainable by the Government on that. So there is a vast amount of tax being lost to the Government. Now, we propose that there be a tax exacted of the beauty shop owner for those preparations because it is unfair to the persons who supply those articles and it is a means of evading the tax.

Senator VANDENBERG. You are also interested in protecting competitively your own clients at that point?

Mr. BROUDY. Of course; yes.

The CHAIRMAN. What is your proposed amendment?

Mr. BROUDY. The proposed amendment is that section 2402 of the Internal Revenue Code be changed by adding to the section a provision to the effect that articles sold by wholesale suppliers for resale be deemed not retail sale but that when the same are actually resold

by the beauty shop owner, that they then be deemed to have been sold at retail, and that the tax be payable by the barber shop or beauty shop owner, and that the returns be made monthly, as now provided in the law and under the regulations. And, furthermore, that for the purposes of the act any article described in subsection (a) shall be subject to tax where such article is manufactured for use in the treatment of patrons by any person operating a beauty parlor, barber shop, or similar establishment, and the tax payable by such person upon the use of such article at the rates set forth in the act shall be based upon the cost to the taxpayer of the same or similar articles not manufactured by the beauty shop owner.

Now, of course, if those two suggestions are considered favorably by this committee and if they become law, the method of calculation on the part of the beauty-shop owner will be quite simple. All he has to do then is pay his tax each month on those articles purchased for use, and during the same months pay a tax on those articles actually resold.

I should like an opportunity to present a brief in connection with the point urged in my discussion before the committee.

The CHAIRMAN. Yes, sir; you may prepare it and give it to the clerk.

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

BRIEF ON BEHALF OF BEAUTY AND BARBER SUPPLY INSTITUTE, OF NEW YORK, N. Y., AND INTERNATIONAL HAIRDRESSERS ASSOCIATION, WITH RELATION TO A PROPOSAL FOR THE AMENDMENT OF SECTION 2402 OF THE INTERNAL REVENUE CODE

To the Honorable Chairman and Gentlemen of the Senate Finance Committee of the United States:

I. PURPOSE OF THIS BRIEF

This brief is respectfully submitted in amplification and extension of the remarks of David M. Broudy, made before your committee on July 28, 1942, and recorded in hearings on H. R. 7378, unrevised, part IV, on page 219. No change is here proposed in the rate of tax or the substantive provisions of the existing law. The changes proposed are purely and simply of an administrative nature.

II. THE INDUSTRY

The toilet-preparations industry so far as the wholesalers are concerned is sharply divided into two groups, the first of which sells to drug and department stores, and the second of which sells to beauty and barber shops. It is this division within the industry which makes it necessary for a revision to be made in the present law taxing the sale of toilet preparations.

III. THE RETAIL EXCISE TAX ON TOILET PREPARATIONS

When, in 1941, Congress decided to abolish the manufacturers' excise tax on toilet preparations and substitute therefore a retailers' excise tax on toilet preparations, the House of Representatives enacted a bill which took into account this division in the industry discussed above. That bill failed to become law because the Bureau of Internal Revenue objected to the difficulties inherent in its administration.

In place of the original House bill, the present law was enacted imposing a 10 percent retailers' excise tax on the sale of toilet preparations, but failing to take into account the division of function within the industry.

The proposal here made is for an administrative change in the present law which will take that division of function into consideration, and yet avoid the objections to the 1941 House bill.

IV. NEED FOR ADMINISTRATIVE CHANGE

The present law creates a discrimination between those wholesalers in the industry who sell to the beauty and barber shops, and those wholesalers who sell to drug and department stores. Wholesalers in selling to drug and department stores are not required to report their sales and pay a tax to the Government because the sale to such retail organizations is not considered under the law a sale at retail. On the other hand a sale by wholesalers to beauty and barber shops is considered a sale at retail and hence taxable as such.

This discrimination between the two types of wholesalers is made more onerous to the industry by reason of the fact that the sale is taxable regardless of whether the goods are purchased by the beauty or barber shop for use in the shop or for resale in consumer packages to their customers.

V. HOME MANUFACTURED TOILET PREPARATIONS

Another objection to the present law which this proposal is designed to remedy is that the law fails to tax merchandise manufactured by the beauty and barber shop for its own use. This failure is an incentive to the manufacturer of "home brew" merchandise upon which no tax need be paid. Since the passage of the present law, the manufacture of this type of merchandise has been on the increase. We propose to amend section 2402 by adding thereto a new subsection, to wit, section 2402 (c), which will make taxable "home brew" merchandise in the same manner as merchandise purchased from suppliers.

VI. OPERATIONS OF BEAUTY AND BARBER SHOPS

Just as there is a division among wholesalers in the industry, so there is a separation of goods purchased by the beauty and barber shops. The beauty or barber shop purchasing toilet preparations purchases two types. One type is known as the professional size and the other type is known as the consumer size. Each size is purchased separately, comes in different containers, and is used for different purposes—the professional size being used within the shop in treatment of its patrons and the consumer size being resold by the shop to its customers.

The present law requires the beauty shop and barber shop as a matter of practice to pay in advance to the wholesaler the tax upon all goods purchased whether for consumption or resale and the goods purchased for resale may lie on the shelves of the shop for many months before resale. When they are finally sold the beauty shop or barber shop is then required to make a return to the Government and pay the tax upon the difference between 10 percent of the sale price to the consumer and the amount charged by the wholesaler for the tax on the original sale.

VII. CHANGE PROPOSED

The proposal here made is designed so to amend section 2402 (b) of the Internal Revenue Code as to do away with the inequitable features of the present law by accomplishing the following:

1. Prevent the sale by the wholesaler to the beauty or barber shop from being treated in any other way than a sale by a wholesaler to a drug or department store.

2. Avoid the necessity of having the beauty and barber shop pay in advance the retailers' excise tax upon goods which are purchased by the beauty shop for resale.

3. Avoid making it necessary for the beauty shop or barber shop having to file a separate return on goods on which it has long since paid the tax.

These objectives can be accomplished by a simple administrative change in the statute. Attached hereto and made a part hereof and marked "Exhibit A" is a statement of the proposed amendment which would accomplish these desirable objectives.

VIII. DISCUSSION

The first objective to be accomplished is to avoid discrimination between wholesalers selling to drug and department stores and wholesalers selling to beauty and barber shops. A sale by the former is not subject to tax because it is not considered a sale at retail, but a sale by the latter is subject to tax because under the express provisions of the present law it is considered a sale at retail regardless of whether the goods are purchased for use or resale. The very same items sold by the two groups of wholesalers are taxed differently even though the purpose of the purchase in each case is absolutely identical. To avoid this unnecessary discrimination, we propose that the return on sales made by beauty and barber shops shall be made by the beauty shop or barber shop just as they are made by the drug or department store.

The second objective is to permit the beauty or barber shop purchasing the goods for resale to pay the tax only when the retail sale is actually made and not, as under the present law, well in advance of such resale. To accomplish this, we propose that the beauty shop or barber shop purchasing goods for resale or for use within the shop be required to file a return reflecting both the goods purchased for use and the goods purchased for resale, and to include in that return those goods purchased for use during the particular month and those goods resold during the particular month, in this way making only one return necessary. The tax upon the goods purchased for use would, as now, be based upon the cost to the shop and the tax upon the goods resold would, as now, be based upon the resale price.

In this way, the third objective is accomplished, and, automatically, the beauty shop and barber shop would be relieved of having to file a separate return upon goods resold.

IX. ARGUMENTS

The arguments in favor of treating the two types of wholesalers in the same way is, of course, obvious. This is a discrimination which has no basis in law and in fact and should be abolished. But the discrimination works not only to the detriment of the wholesaler but to the detriment of the beauty shop and barber shop as well. By adopting the change here proposed, the beauty and barber shop will be relieved of having to pay the tax in advance. It would be necessary for the shop to make a return and report a tax once a month as under the present law, but the return will reflect only so much of the goods purchased for resale as were actually sold within that month and hence the shop will pay the tax to the Government only after receipt by it of the purchase price from the consumer, which is the only equitable and fair way in which the retail excise tax should operate.

Since it is obviously fair for the beauty shop and barber shop to pay the tax only upon receipt of the sales price for the resold merchandise, it will be no greater effort for the shop to include within that return the amount of goods purchased for professional use during that month, paying the tax on both at the same time.

In this way, the Bureau of Internal Revenue will not be forced, as it presently is, to examine two sets of returns, one from the beauty shop and one from the wholesaler. In addition, greater revenue will result to the Government because the resale of toilet preparations will thereby be encouraged.

The beauty shop and barber shop cannot afford at the present time to finance the tax in advance and therefore has, since the enactment of the present law, been largely discouraged from buying resale merchandise. Sales of such merchandise have fallen off considerably and it is the inevitable result of the present proposal to encourage these sales and thereby to yield greater revenue to the Government.

Furthermore, under the present law, the beauty shop and barber shop when reselling merchandise and making its separate return, is permitted to credit against the tax payable to the Government on such resale, the amount of tax already paid to the wholesaler on the original purchase. The shops are not equipped to do this job and are making inaccurate returns to the Government, either paying too much or too little. This, in turn, requires the Bureau of Internal Revenue to make extensive investigations and impose assessments and penalties which would in every case be avoided by the proposed enactment.

X. SUMMARY

The change in section 2402 (b) here proposed is an administrative change which would require the beauty and barber shops, rather than its supplier, to make the return and pay the tax directly to the Government, both with regard to professional and resale merchandise, for the following reasons:

1. Such a change will eliminate the discrimination presently existing between the two groups of wholesalers mentioned above.

2. The proposed change will eliminate the necessity for the beauty shop and barber shop having to pay its tax in advance of resale.

3. The proposed change will make it unnecessary for the beauty shop and barber shop to file a separate return as is now required under the law when goods purchased for resale are resold.

4. The proposed change will make it unnecessary for the Bureau of Internal Revenue to inspect two sets of returns, one by the wholesaler and one by the beauty and barber shops on the same merchandise, and will therefore make the process of administration less expensive.

5. The proposed change will yield greater revenues to the Government by giving an added incentive to the beauty and barber shop to purchase merchandise for resale.

The proposed addition to section 2402, to wit, section 2402 (c) taxing "home brew" merchandise in the same manner as merchandise purchased from regular suppliers will give increased revenue to the Government by taxing a source which is now tax free and also will stabilize the industry by avoiding a disruption in the industry which has been fostered by the present law.

XI. CONCLUSION

For the reasons urged above, we propose that section 2402 shall be amended as indicated in exhibit A hereto attached.

Respectfully submitted.

BEAUTY & BARBER SUPPLY INSTITUTE, INC.,
By JOSEPH BYRNE.
INTERNATIONAL HAIRDRESSERS ASSOCIATION,
By B. J. RUTKOE,
WALTER C. B. SCHLESINGER,
Counsel.

EXHIBIT A

SEC. 2402. TAX ON TOILET PREPARATIONS.—(a) TAX.—There is hereby imposed upon the following articles sold at retail a tax equivalent to 10 per centum of the price for which so sold: Perfumes, essences, extracts, toilet waters, cosmetics, petroleum jellies, hair oils, pomades, hair dressings, hair restoratives, hair dyes, aromatic cachous, toilet powders, and any similar substance, article, or preparation, by whatsoever name known or distinguished; any of the above which are used or applied or intended to be used or applied for toilet purposes.

(b) BEAUTY PARLORS, ETC.—For the purposes of subsection (a), the sale of any article described in subsection (a) to any person operating a barber shop, beauty parlor, or similar establishment shall not be considered a sale at retail; but the acquisition for use by the operator of such barber shop, beauty parlor, or similar establishment in the treatment of its patrons of any article described in subsection (a) shall be considered subject to tax and any person operating such barber shop, beauty parlor, or similar establishment shall pay a tax thereon at the rate set forth in subsection (a) based upon the purchase price thereof to such person: *Provided, however*, That in the case of such articles intended for resale after acquisition, no tax shall be payable until such articles are resold, and in the event of such resale, the tax shall be paid by the vendor based upon the resale price thereof.

(c) For the purposes of subsections (a) and (b), any article described in subsection (a) shall be subject to tax as in subsection (b) where such article is manufactured for use in the treatment of patrons by any person operating a beauty parlor, barber shop or similar establishment and the tax payable by such

person upon the use of such article at the rate set forth in subsection (a) shall be based upon the cost to the taxpayer of the same or similar articles not manufactured by himself.

The CHAIRMAN. All right, Mr. Marsh.

STATEMENT OF BENJAMIN C. MARSH, WASHINGTON, D. C., REPRESENTING THE PEOPLE'S LOBBY

Mr. MARSH. Mr. Chairman and members of the Finance Committee, I appear on behalf of the People's Lobby, with offices here in Washington. As I think most of you know, Bishop Francis J. McConnell, of the Methodist Church in New York, is president of the People's Lobby.

I want to make some suggestions which I hope will not run counter to the decisions of the committee as I inferred them from the story in the New York Times this morning, that you did not want to consider anything that is not in the bill, because I trust that you will not permit the House bill to pass. It will be such a shock to our boys in uniform that it will impair their morale.

We suggest that this war has got to be paid as you go, and I will say very frankly that I think if the Congress does not adopt the policy of pay as you go in the main, for this war, that you should right now create a commission to study the tactics and techniques of repudiation, because I believe, very frankly, that that is the only alternative.

Perhaps I should apologize for the fact that I am going to suggest taxes which are going to make practically all of our members—not quite all—pay a good deal more taxes, and you can sympathize with me when I tell you if you adopt my proposal we are going to lose some of our large contributors; so I hope you adopt it, because, after all, there is more involved than keeping some organizations going, however much they may be needed.

Since the increase in the national income this year and in 1943 over 1940 will be within about ten or twelve billion dollars of the actual expenditures for war, it is obvious that a war deficit of ten or twelve billion dollars is all that need be incurred in each of these years, and the balance should be raised by taxes.

I am going to list where you can raise $40,000,000,000. It is not up to me to pass the law. You can raise them from the individual income taxes, including tax on interest of exempt bonds, $11,000,000,000. Corporation income and excess-profits tax, $12,000,000,000. I want to go into detail on these a little later.

Corporation surplus and undivided profits, $12,500,000,000.

Excise tax on land values, $500,000,000.

General excise and tariff taxes, $2,300,000,000.

Estate, gift, capital-stock taxes, and so forth, $700,000,000.

Social security taxes, $1,000,000,000.

The New Deal has long practiced the art of living off the next generation, which is worse than living off his wife's folks, and an im-

perialist war could be won by so passing the bill to posterity—or perhaps you would put it: Passing the buck to Providence—but ending aggression and establishing three to five freedoms in the four corners of the earth by a global war cannot be achieved by our present methods of frenzied and fantastic finance.

I would say this, I would be perfectly willing to submit our tax program to the boys in uniform as compared to the sales tax, or leaving it for them to pay part of the cost, or most, when they get back. I think it would be public service if this committee would ask the Gallup poll to take a poll of the boys in uniform whether they would rather have us here at home pay for the war as we go, or leave it for them to do it in large part when they get back.

The Government determines how many soldiers and other war manpower it needs, and drafts that many: A democratic government would determine how much money the war will cost, ascertain where that money is, and then put property and income on a fiscal parity with draftees. I think that is good democracy—as was, when I knew Woodrow Wilson personally. I do not know how it comports with present concepts.

If the war continues into 1944, Congress will have to impose a progressive capital levy, with a moderate exemption.

On that point, I would like the permission of the committee to insert into the record a proposal for a graduated capital levy drafted by a former Member of this body, Senator Elmer A. Benson, of Minnesota, and also former Governor of that State. It is a short table.

The CHAIRMAN. You may put it in, Mr. Marsh.

(The table referred to is as follows:)

PROPOSAL FOR GRADUATED CAPITAL LEVY, BY HON. ELMER A. BENSON, APPLETON, MINN.

The proposed tax or capital levy would be in effect for 1 year and would be levied on the total value of all property owned by individuals at a graduated rate from 1 to 20 percent, and the tax would be payable in 18 monthly installments with a 6-percent discount for payment in advance. Married persons would be given a credit in paying the tax of $500 and single persons a credit of $300. A table for computing the tax and an example of the tax to be paid by a married person and a single person is attached.

Table for computing tax

Property taxable	Rate	Total tax	Property taxable	Rate	Total tax
	Pct.			*Pct.*	
Under $10,000	1	$100	$100,000 to $200,000	11	$16,500
$10,000 to $20,000	2	300	$200,000 to $300,000	12	28,500
$20,000 to $30,000	3	600	$300,000 to $400,000	13	41,500
$30,000 to $40,000	4	1,000	$400,000 to $500,000	14	55,500
$40,000 to $50,000	5	1,500	$500,000 to $600,000	15	70,500
$50,000 to $60,000	6	2,100	$600,000 to $700,000	16	86,500
$60,000 to $70,000	7	2,800	$700,000 to $800,000	17	103,500
$70,000 to $80,000	8	3,600	$800,000 to $900,000	18	121,500
$80,000 to $90,000	9	4,500	$900,000 to $1,000,000	19	140,500
$90,000 to $100,000	10	5,500	All over $1,000,000	20	

Examples:

PROPERTY VALUE, $30,000

Tax on first $10,000	$100
Tax on second $10,000	200
Tax on third $10,000	300
Total tax	600
Credit (married person)	500
Tax payable	100

PROPERTY VALUE, $30,000

Tax on first $10,000	$100
Tax on second $10,000	200
Tax on third $10,000	300
Total tax	600
Credit (single person)	300
Tax payable	300

Mr. MARSH. At the end of 1939 the surplus reserves and surplus and undivided profits of all corporations were about $58,000,000,000, of which 395 corporations, less than one-tenth of 1 percent of all, had nearly two-fifths. These are the last figures I could get, although the Treasury can get the figures on corporate incomes and assets for 1940 and possibly for 1941. These corporations held $27,300,000,000 of Government obligations, of which the 395 mammoth corporations held over three-fifths. The position of these great corporations has probably greatly improved since 1939, for they have received the major part of war orders, while the mortality rates among small concerns has been serious.

The Secretary of the Treasury, in his appearance before your committee, referred to the injustice of tax-exempt securities, and we agree. They total, I believe, some $20,000,000,000. That includes Government securities of all sorts. The Secretary failed, for some reason, to suggest that Congress, through an excise tax, tax the $60,000,000,000 of tax-free land values—with an exemption so the small home and farm owner will not be hit further. It is not our province to suggest the rates to yield the revenues we ask, but the Treasury has statisticians and experts who can do this in 2 or 3 weeks, and, of course, you can request them to do that.

I got in the mail this morning, from my friend, Congressman Woodruff, from the State of Michigan, a speech which he made that bears directly on this, and I would like to quote what he said. He said that Dr. Alvin H. Hansen, in an interview printed June 27 in the Chicago Journal of Commerce, made this statement as to the New Deal aims:

> Congress will surrender to the administration the power to tax, keeping to itself the right only to establish broad limits within which the administration may move. Congress will appropriate huge sums of money, will surrender its power of directing when and how the money shall be spent.

I am not quite sure whether this is historical or anticipatory. Continuing the quotation:

> Other extraordinary powers, such as for instance to effect wholesale social reforms, will be delegated to the administration which will retain most if not all of its present extraordinary wartime powers.

Those are the major suggestions.

Now, gentlemen of the committee, I do not think that statement is quite justified. I have noted that in the last few months the most searching, and, in my judgment, beneficial check-up on our war program has been made by committees of Congress. That, it seems to me, affords an argument for my conviction of the importance of retaining a legislative body. If we do not retain a legislative body with coordinate powers we are lost, but in this instance, as a tax measure, I am convinced that the Treasury is correct in its suggestion that we raise a good deal more than the House bill provides.

Frankly, as I stated earlier, I am desperately disappointed, and when the people of the country realize the profits that are being made and how little is being done, I think they will be rather furious.

I made a study recently, based largely on this one little page of statistics issued by the Department of Commerce. I never go to any foreign country to get my information on America. This is based upon this study of the Department of Commerce, and it shows this:

From 1932 to 1941 the national income increased 137 percent.

Salaries and wages increased 97.4 percent.

Income from ownership or control of property increased 273 percent.

That is all based upon these figures to which I have referred, from the Department of Commerce.

Personally, I do not see how you can prevent inflation as long as you have the present and prospective gap between the total income available for purchasing goods and the supply of goods.

I think I was correct when, 18 months ago, in a Nation-wide broadcast under the auspices of "Wake Up, America," I said that we should realize we cannot fight a war against totalitarian powers without a totalitarian organization. I think we are facing that.

Personally, I am unable to understand what advantage it is to labor to get extra wages when they have all got to be taken back in taxes, or most of them, in taxes and in bonds, or what advantage it is to farmers to have an income—what was it last year? About $13,760,000,000, an increase of 26 percent over the preceding year, when they are up against it, by rising prices. But the real issue is not the amount, but how it is distributed.

The Department of Agriculture gave me figures which were highly astounding, and I want to give you just two or three. In 1929, one-tenth of the farmers got 41 percent of the farm income; in 1939 they got 48 percent, and in 1941, nearly 50 percent or one-half.

I am always delighted to read my friend's—the Vice President's—talk about the century of the common man, and I hope he will have better luck with it than he did when he was Secretary of Agriculture, since the little farmer got less and the big farmer got more, but of course I do not know whether you want that to go into the record. It might be considered criticism, but I was brought up on the old-fashioned theory that the proof of the pudding is in the eating; not in the political talk about it.

Also you talk about sales taxes. Anybody in his right mind will not accuse the Gallup Poll of being an extremely radical institution,

but it issued, on the 19th of this month, results of a poll which the New York Times headlined: "War prosperity not evenly spread." That is no news, of course, but still fit to print.

This is what it shows—and this is for nonfarm families:

Seven percent of individuals in America earned under $10 a week. That reminded me at once of a squib I read in the Philadelphia Bulletin about 35 years ago. The question was: "Can a man be a Christian on $3 a week?" The answer was: "A man cannot be anything except a Christian on $3 a week."

Well, you may be a good Christian, but you cannot be very patriotic on an income of $10 a week, with the price of things going up. Of course, Leon Henderson is doing the best he can, with the wisdom God gave him and the appropriation Congress gave him, but you just cannot succeed with that kind of hit-or-miss price fixing.

Of course, you know our contention, and I think the record that Russia is making, justifies it, that you cannot get either wholehearted fighting nor adequate war production under the system of private profits.

I would like the permission of the committee to read several things in the record. I do not know what you are going to do on this bill. I sincerely hope the papers are not correct in reporting that you are going to wait until after election, not because I object to election, not because I want to see some of the prospective purgees licked, or anything of that sort, but I think folks ought to know in advance what they are going to have to pay. Personally, I do not object in the slightest to such rates of taxes as needed to pay as we go. I do not like a flat limit of a $25,000 income, but we would be put in the British or Canadian class if we had a system of taxes which would leave people a maximum of around $25,000—and I know several people who have such income, or a good deal over it. I do think that it is fair to give them a little advance notice.

If you will permit a little illustration, I was talking with a wealthy gentleman in New York when that story about income limitation came out. He said: "I have two boys in the British R. A. F." Their boys, I believe get $125 a month, and I think ours get about $350 or $400, and I do not begrudge them a cent of it, I want to pay more taxes to meet it. He said: "One of them brought down 19 German planes. I have another boy who just started. Both have families, with young children. I am giving each $10,000 a year to keep him going. I ought to have a little notice if I am going to be limited to $25,000." I said: "Of course, they can reduce their standard of living." I have lived on very much less than $10,000 very comfortably, merely 15 percent of it. I do not think you ought to pass a law without letting them know in advance what is going to happen as all of us have got to adjust our standards of living.

If we come to the end of this war with a $250,000,000 000 debt it is going to be repudiated or we are going to try to emulate Hitler to pay it off. I doubt if there is any choice between the two alternatives, not that we want to, but that is what we are going to be up against.

I have taken from the Treasury Department an analysis of the set-up of industrial corporations showing their surplus and undivided

profits, and then I made a case study of some of the big corporations, and I think it would be in order in view of the big story about General Motors this morning in the New York Times: "Income cut in half"—I think it is proper to call attention to this fact. These are the individual corporations. At the end of last year General Motors Corporation and its consolidated subsidiaries held $285,000,000 of Government securities. Now it looks to me as though they were scheming a grand trick not to pay taxes. You know more about business organizations than I do, although I have earned most of my living since I was 14 and that gives you a practical slant on life.

I think the Members of this Congress will agree as to the efficiency of General Motors in producing war material, and that is the one thing you and I are concerned in, to get the maximum production at a fair price for our boys in uniform, and to end the war victoriously for us as soon as possible.

Suppose you take $100,000,000 of $150,000,000 of those Government securities from General Motors, they would not go broke. They have have some rather funny financing. Let me give you a few figures. Suppose back in 1908 a man had invested $10,000 in 100 shares of General Motors at $100 each, by 1936, through a split-up in stock, he would have owned 25,095 shares of General Motors, and received on that investment 26 years earlier, an investment of $10,000, he would have received approximately $1,180,000 in dividends. I have a little stock, I don't know what is in it because somebody handles it for me, but such profits are scandalous.

It does seem to me it is about time that we recognized that all we have to do to understand dictatorships is to study democracies. We have got to face up with the facts.

This tax bill is before you for prompt action, but I do not see how you are going to get anywhere in the war effort much longer without Government taking over, or complete Government control of all industry. We have already incurred a huge debt, and I have a strong suspicion that the next generation is going to say: "Listen, you told us you fought the World War to end war, and, by golly, it was only 17 years afterward that the next World War started in Spain." Incidentally, we were on the wrong side there. They are not going to admit that this war is to save posterity, and pay it by 50- or 30- or 40-year bonds, even if the interest on it is subject to taxation. I hope that this committee will call upon the Treasury experts to give you the tax rates to pay as we go, and they can get them certainly within a month, because there are very able statisticians there, and fiscal experts and actuaries; and let us adopt some such program.

Incidentally, I think it would be a very great encouragement to our Allies, who are a little bit worried, some of them, people in the United Nations, and members of the United Nations, as to what we are doing.

If you think I have been extreme, I would like to read into the record this article from the Journal of Electrical Workers and Operators of April 1942. The caption reads: "Profits, profits, profits! profits, profits, profits!" and they give the figures.

Take one of the aviation companies. An increase in 1 year of 728 percent seems more than reasonable. Another aviation corporation,

an increase in profits of 2,677.7 percent! I would like to read those into the record so as to fortify the members of this committee, to get your conscience to the point which mine has reached, and the People's Lobby has reached, on this; and also this brief summary from the Internal Revenue Reports on Corporation Incomes for 1939, with a case study of these corporations, and you realize that United States Steel, Bethlehem Steel, and General Motors, covered, all have shared rather generously in Government contracts.

(The matter submitted is as follows:)

Data on industrial corporations for 1939, compiled from the 469,617 returns filed with the Treasury Department and reported by it

[In millions]

Major receipts taxable:		
Gross sales		$101,575.8
Gross receipts from operations		22,295.8
Interest		2,443.6
Rents and royalties		2,318.9
Net capital gain		211.9
Dividends from domestic corporations		1,005.9
Dividends from foreign corporations		250.1
Other receipts		997.7
Interest on Government obligations		763.4
Subject to excess-profits tax	$320,192	
Wholly tax-exempt	443,250	
Major deductions:		
Cost of goods sold		77,272.1
Cost of operations		11,128.0
Compensation of officers		2,697.5
Interest paid		2,796.5
Taxes paid		3,995.4
Depreciation		3,442.7
Other deductions		20,232.7
Income, profits, and taxes:		
Net income		6,734.6
Total tax		1,252.3
Net profit less total tax		5,945.6
Dividends paid, other than corporation's stock		5,746.7
Stock dividends		85.8

For 1939, 515,960 corporations filed returns.

Of these, 199,479 show a net income of $8,826,713,029; 270,138 reporting no net income, show a deficit of $2,092,147,535—while 46,343 inactive corporations have no income data.

Capital structure of corporations

Corporation with net income (compiled by Treasury Department from 187,920 balance sheets):	
Cash	$28,106.4
Notes and accounts receivable, less bad debts	31,487.7
Investments, Government obligations	17,236.3
Other investments	49,690.6
Net capital assets	61,734.3
Total assets	206,670.9
Capital stock preferred	12,678.3

Capital structure of corporations

Corporation with net income—Continued.		
Capital stock common		$53,969.4
Surplus reserves		5,940.9
Surplus and undivided profits		40,207.6
Less deficit defined as "negative amounts of 'paid-in' or capital surplus' and 'earned surplus and undivided profits' "		2,449.0
Nonbusiness receipts		
Partly and wholly tax-exempt interest		456.1
Subject of excess-profits tax	$258.9	
Wholly tax exempt	197.2	
Interest		1,347.3
Rents and royalties		1,124.2
Compiled net profit less total tax		7,668.4
Dividends paid exclusive of own stock		5,475.7
Corporations reporting no net incomes:		
For 1939, 224,839 corporations reporting no net income filed balance sheets showing—		
Cash		5,927.1
Notes and accounts receivable, less bad debts		7,962.8
Investments—Government obligations		10,116.2
Other investments		31,465.3
Net capital assets		38,491.8
Total assets		100,130.4
Capital stock preferred		4,577.0
Capital stock common		19,512.4
Surplus reserve		1,906.3
Surplus and undivided profits		11,094.3
Less deficit (defined as above)		10,573.4
Nonbusiness receipts:		
Partly and wholly tax-exempt interest		294.6
Subject to excess-profits tax	$54.5	
Wholly tax exempt	240.1	
Interest		1,058.0
Rents and royalties		1,083.0
Compiled net loss after taxes		1,669.7
Dividends paid, exclusive of own stock		163.0
Corporations with $100,000,000 and over total assets for 1930—395 corporations with $100,000,000 and over total assets, filed balance sheets showing:		
Cash		16,679.2
Notes and accounts receivable, less bad debts		12,819.0
Investments, Government obligations		17,160.2
Other investments		49,979.4
Net capital assets		40,866.3
Total assets		144,204.9
Capital stock prefererd		6,534.8
Capital stock common		29,517.3
Surplus reserves		3,719.8
Surplus and undivided profits		18,514.4
Less deficit (defined as above)		1,208.4
Nonbusiness receipts:		
Partly and wholly tax-exempt interest		446.3
Subject to excess-profits tax	$784.4	
Wholly tax exempt	263.9	
Interest		1,253.0
Rents and royalties		317.6
Compiled net profit less total tax		2,364.1
Dividends paid, exclusive of own stock		2,187.1

The mammoth corporations[1]

These Treasury statistics reveal:

The 395 corporations having in 1939 total assets of $100,000,000 and over, less than one-tenth of 1 percent of all corporations filing balance sheets had, that year—

1. Nearly half the cash.
2. Nearly one-third of all notes and accounts receivable, less bad debts.
3. Over three-fifths of all Government bonds.
4. Nearly five-eighths of all other investments.
5. Two-fifths of capital assets.
6. Nearly half of total assets.
7. Over one-third of value of preferred stock.
8. Nearly three-sevenths of value of common stock.
9. Nearly half of surplus reserves and surplus and undivided profits—after deducting "negative" surplus reserves, etc.
10. Nearly two-fifths of surplus reserves and undivided profits—before deducting such "negative" surplus reserves, etc.
11. Nearly three-fifths of interest on Government bonds subject to the surtax.
12. Over three-fifths of interest on Government bonds wholly tax-exempt.
13. Over half of interest collected.
14. One-seventh of rents and royalties collected.
15. Nearly two-fifths of net profit less total tax.
16. They paid nearly two-fifths of all dividends paid by corporations.

No net income corporations

1. Net capital assets of corporations reporting *no* net income were $38,491.8 million, nearly two-thirds as much as of those with net income.
2. Their surplus reserves and surplus and undivided profits were $13,000.6 million—over one-fourth of those of corporations, reporting net income—though they call their negative paid in or capital surplus—a deficit.
3. They held $10,116.2 million of Government obligations—nearly three-fifths as much as corporations reporting net income, and received in partly and wholly tax-exempt interest thereon $294.6 million, or $24 million more than three-fifths as much as net-income corporations.

Data given in annual reports for 1941

[000 omitted]

UNITED STATES STEEL CORPORATION

Cash in banks and on hand	$282,063
United States Treasury tax anticipation notes	69,080
Cash segregated for capital expenditures	60,000
Accounts and notes receivable, less reserves	140,600
Fixed assets:[2]	
Real estate	90,747
Plant, mineral, and manufacturing	1,900,506
Transportation—railroad, lake, and ocean steamers	404,077
Investment in mine stripping, etc	15,346
Total	2,410,675
Current liabilities	287,667

[1] The position of mammoth corporations has improved absolutely and relatively to other corporations, since 1939, because they have received the major part of Government war orders, and their expansion, conversion, and new construction for war production, has been almost entirely at Government expense—"riskless private enterprise."

Even at the end of 1939, however, the net capital assets of the 395 dominating corporations were about two-thirds of the present national debt, and their holdings of Government bonds with interest wholly or partly tax-exempt, were over a fourth of this debt.

Their surplus reserves, surplus and undivided profits, and cash, were nearly two-thirds of the present national debt—and are probably a much larger proportion now.

[2] The notation is made above fixed assets—"Less reserves for depletion, depreciation, amortization, and obsolescence $1,303,083" reducing alleged fixed assets to $1,106,992—but fixed assets at the end of 1941 were $64,759 more than the year before," also "Values are based upon determinations by the U. S. Bureau of Corporations as at the date of organization of the corporation adjusted for additions and disposals since that date."

Long-term debt	$181,238
Preferred stock (issued)	360,281
Common stock (issued)	652,744
Dividends paid	60,133
Surplus for the year	56,138
Capital surplus	38,403
Earned surplus	362,051
Inventories less reserves	291,651
State, local, and miscellaneous taxes	40,946

These figures show:

1. Capital and earned surplus exceed long-term debt by $219,276.
2. Net accounts and notes receivable and net inventories exceed current liabilities by $144,584.

BETHLEHEM STEEL CORPORATION

Cast demand and time deposits in banks		$80,248
U. S. Treasury notes		37,285
Accounts and notes receivable		111,012
Inventories		139,432
Receivable on facilities installed for U. S. Government		17,953
Fixed assets net		456,524
Buildings, machinery equipment	$391,244	
Minerals, including surface lands	34,739	
Other lands, mine stripping, etc	30,541	
Total current liabilities		176,330
Total funded debt		181,778
Preferred stock (7 percent cumulative)		93,389
Common stock		283,574
Surplus		106,902
Dividends paid		24,447
State and local taxes		12,258
Reserves—contingent and insurance		17,936

GENERAL MOTORS CORPORATION AND CONSOLIDATED SUBSIDIARIES

Cash		$196,231
U. S. Government securities		285,081
Short terms at cost	$19,997	
Tax notes at cost	265,084	
Sight drafts and C. O. D. items		3,114
Accounts receivable and trade acceptances less reserves		340,324
Investments		249,160
Miscellaneous assets		8,723
Real estate, plants, and equipment		851,707
Less reserve for depreciation	$441,833	
Net real estate, plants, and equipment		409,874
Goodwill patents, etc		50,323
Capital stock preferred no par value, common $10 par		622,537
Capital surplus		11,082
Earned surplus		493,883
Net sales		2,436,801
Total taxes		287,992
Net income		201,750
Common capital stock		435,000
Amount earned on common capital stock		192,474

Earned per share common stock (par value, $10), $4.44.

GENERAL FOODS CORPORATION AND WHOLLY OWNED SUBSIDIARY CORPORATIONS IN UNITED STATES AND CANADA

Cash		$7,500
Accounts and notes receivable less reserve		14,009
Inventories		57,231
Property accounts		58,532
Reserves for property accounts depreciation		25,864
Capital stock preferred and common [1]		63,403
Earned surplus		28,538
Profit before provision for contingencies		15,653
Provision for contingencies	$1,500,000	
Net profit carried to surplus		14,153
Net profit, after preferred dividends, per share of common stock no par value, $2.56.		
Dividend on common stock, $2 per share		10,503
Dividend on preferred stock, $4.50 per share		675

ARMOUR & CO. OF ILLINOIS AND SUBSIDIARIES

Cash		$18,282
Notes and accounts receivable less reserve		52,175
Inventories		118,999
Land, buildings, machinery, and fixed equipment (including land regarded as available for sale carried at approximately $7,200,000)	$192,147,691	
Reserve for depreciation	61,853,321	
Refrigerator cars, delivery equipment, etc	11,282,277	
Net fixed assets		141,577
Capital stock		77,000
Surplus		69,465
Capital and paid-in surplus	$38,442,494	
Appropriated earned surplus (preferred stock Armour & Co. of Delaware redeemed)	3,371,500	
Unappropriated earned surplus	22,730,054	
Dividends on stock Armour & Co. of Delaware		3,757
Balance transferred to surplus		11,354

[1] Issued—150,000 shares preferred $4.50 cumulative "involuntary liquidation preference $100 a share" $15,000,000 and 5,359,751 shares common stock no par value, valued at $48,402,798.

[From the Journal of Electrical Workers and Operators, April 1942]

PROFITS, PROFITS, PROFITS!
PROFITS, PROFITS, PROFITS!

WHILE ASSAULTS ARE BEING MADE BY REACTIONARY BUSINESS INTERESTS ON LABOR'S STANDARD OF LIVING, PROFITS SOAR

Industry certainly is making hay while the sun shines. It is as though the hands of the clock had been turned back and the lustrous days of 1929 were here all over again.

The combined net profits for 629 large industrial corporations after the payment of all interest and other fixed charges and taxes (but before the payment of dividends) aggregated in 1941 a total of $2,181,000,000. This was an increase of 20 percent over their total $1,818,000,000 net profit in 1940. The March 1942 issue of the Federal Reserve Bulletin reports net industrial profits by major industrial groups. Oil, machinery, and durable goods production, all showed magnificent increases in profits during the past year.

RICH HAUL FOR RAILROADS

The Interstate Commerce Commission has recently announced the combined net operating income of 137 class I railroads for 1941 to be $999,502,906. Com-

pare this with the $682,543,218 net of 1941—an increase of $317,000,000, or 46 percent. Railroad net income after taxes as reported in the Federal Reserve Bulletin (March 1942) was $191,000,000 in 1940 and $502,000,000 in 1941, over two and one-half times greater than in 1940.

The great increase in 1941 railroad income was attributed to troop movements and freight for the national defense industries. Despite the fact that the recently-awarded increases in railroad wages will add $315,000,000 annually to railroad pay rolls plus $75,000,000 in back pay, prospects for 1942 are better for the railroad industry than at any time since 1929, when net income after taxes neared the $900,000,000 mark. Much of the added payroll load will be offset by the 10 percent increase in interstate passenger fares granted by the Interstate Commerce Commission on February 10, 1942, and the 6 percent boost in freight rates granted on March 2.

At the present time railroads are hauling 800,000 carloads of freight a week, or more than at this time last year. By midsummer the number is expected to reach 900,000 cars weekly, and when wheat begins to move in the fall it may approach 1,000,000.

PRODUCTION PEAKS IN STEEL

The steel industry of this country has a total capacity of about 84,000,000 tons a year. Seven companies own over three-quarters of it. The United States Steel Corporation has over one-third of the Nation's total capacity. Bethlehem Steel, the second largest, has a little under one-sixth. The third largest, Republic Steel, has less than one-tenth. Jones & Laughlin, National, Youngstown Sheet & Tube, and Inland following in that order. They are all considerably smaller than Republic.

The American Iron & Steel Institute has recently announced that with the exception of the output of steel rail and certain types of pipe, new production peaks were set in 1941 for practically all major classes of steel products.

The great increase in profits in the steel manufacturing industry came in the latter half of the year 1940. Since then the industry has been operating at nearly full productive capacity and earnings have been more or less stabilized, pending the completion of new productive capacity now under construction or a change in the steel price structure. Nevertheless, the combined net income, after payment of taxes and all other charges, for the seven chief companies, increased from $222,600,000 in 1940 to $238,800,000 in 1941, or 7.3 percent. The 1941 figure is 2.2 times the aggregate $108,100,000 net earnings of the seven companies for 1939.

Among the smaller and more specialized steel manufacturing companies profits for the year 1941 were also often spectacular.

In the tables below net profits for the past 2 years are presented for combined industrial groups and for specific steel, railroad, aircraft, oil, rubber, copper, machinery, and other representative companies. In all cases the net earnings shown are after allowances have been made for the proper payment of taxes.

Net profits of leading industries

Industrial group	Millions of dollars		Net increase, percent
	1941	1940	
Total net profits (629 large industrial corporations)	2,181	1,818	20.0
Iron and steel	322	278	15.8
Machinery	197	158	24.7
Automobiles and other transportation equipment	497	415	19.8
Nonferrous metals and products	155	133	16.6
Other durable goods	112	88	27.3
Foods, beverages, and tobacco	166	148	12.2
Oil production and refining	173	112	54.5
Industrial chemicals	205	194	5.7
Other nondurable goods	192	160	20.0
Miscellaneous services	156	132	18.2

Net profits of railroads

	Net income, 1941	Net income, 1940	Net increase, percent
Atchison, Topeka & Santa Fe	$30,236,581	$12,745,371	137.2
Atlantic Coast Line	11,132,472	1,823,537	510.1
Baltimore & Ohio	21,091,883	5,549,497	280.1
Chesapeake & Ohio	44,419,162	32,452,209	36.9
Chicago, Burlington & Quincy	10,418,142	4,392,894	137.2
Delaware, Lackawanna & Western	3,671,698	205,277	1,688.7
Erie R. R. System	7,930,528	14,263	55,602.1
Illinois Central	10,557,195	1,296,619	714.2
New Orleans & Northeastern	1,108,099	311,055	256.2
New York Central	26,245,562	11,265,084	133.0
New York, Chicago & St. Louis	12,588,528	3,512,157	258.4
Pennsylvania R. R	52,383,958	40,775,830	28.5
Southern Pacific	34,573,667	7,146,349	383.8
Southern Railway	19,369,804	7,352,072	163.5
Union Pacific	28,857,420	19,445,880	48.4

Net profits of tool and machine producers

	1941	1940	Increase, percent
American Machine & Metals Co	$735,980	$106,376	591.9
Chicago Pneumatic Tool Co	2,766,602	1,717,602	61.1
Clark Equipment Corporation	2,181,507	1,536,933	41.9
General Machinery Corporation	1,450,334	972,831	49.1
Mesta Machine Corporation	3,607,738	3,083,032	17.0
Monarch Machine Tool Co	1,500,424	1,183,102	26.8
National Acme Co	3,145,104	2,199,148	43.0
Sundstrand Machine Tool Co	1,171,893	953,763	22.9
Worthington Pump & Machinery Co	2,909,022	2,236,158	30.1

Net profits of major steel companies

[— indicates net decrease]

	Millions of dollars			Net increase—	
	1941	1940	1939	Since 1940, percent	Since 1939, percent
United States Steel	116.0	102.2	41.1	13.5	182.2
Bethlehem Steel	34.5	48.7	24.6	—29.2	40.3
Republic Steel	24.0	21.1	10.7	13.7	124.3
Jones & Laughlin	16.3	10.3	3.2	58.3	409.4
National Steel	17.1	15.1	12.6	13.2	35.7
Youngstown Sheet & Tube	16.1	10.8	5.0	48.3	222.2
Inland Steel	14.8	14.4	10.9	2.8	35.8
Total net profits	238.8	222.6	108.1	7.3	120.9

Net profits of aircraft production

	1941	1940	Increase, percent
Air Associates, Inc.[1]	$456,555	$409,265	11.6
Aviation Corporation, The[2]	2,464,142	88,350	2,677.7
Bell Aircraft Corporation	1,970,645	284,745	592.1
Bendix Aviation Corporation	13,545,995	9,310,074	45.5
Consolidated Aircraft	8,024,882	[3] 1,400,645	
Douglas Aircraft [2]	18,176,090	10,831,971	67.8
Lockheed Aircraft Corporation	6,668,621	3,165,675	108.8
North American Aviation, Inc.[4]	2,738,543	2,362,708	15.9
Vultee Aircraft, Inc.[2]	3,100,735	374,457	728.1

[1] Data for years ending Sept. 30, 1940 and 1941.
[2] Data for years ending Nov. 30, 1940 and 1941.
[3] Data for 11 months ending Nov. 30, 1941.
[4] Data for quarter ending Dec. 31, 1940 and 1941.

Net profits of oil companies

	1941	1940	Increase percent
Atlantic Refining Co	[1] $14,348,000	$6,217,453	[1] 130.8
Barnsdall Oil Co	5,026,202	2,193,471	129.1
Columbia Oil & Gasoline	2,091,624	1,411,234	48.2
Consolidated Oil Corporation [2]	3,471,941	2,080,027	66.9
Houston Oil Co	1,352,886	870,657	55.4
Phillips Petroleum Co	17,436,977	11,590,317	50.4
Pure Oil Co	15,285,255	8,718,057	75.3
Quaker State Oil Refining	1,539,127	347,892	342.5
Standard Oil Co. of California [2]	24,613,108	16,730,170	47.1
Standard Oil Co. of Indiana	48,385,967	33,597,342	44.0
Sun Oil Co	16,532,540	7,969,068	107.5
Texas Co	51,874,681	31,547,662	64.4

[1] Estimate.
[2] Data for 6 months ending June 30, 1940 and 194..
[3] Data for 9 months ending Sept. 30, 1940 and 1941.

Net profits of minor steel companies

	1941	1940	Increase, percent
Continental Steel Corporation	$1,225,674	$778,738	57.4
Crucible Steel Co. of America	7,349,480	6,083,257	20.8
General Steel Castings Corporation	3,290,429	1,106,190	195.3
National Malleable & Steel Castings Co	1,779,740	1,475,956	20.6
Pittsburgh Steel Co	3,109,597	1,556,000	103.7
Rustless Iron & Steel Corporation	2,334,627	1,275,993	83.0
Sharon Steel Corporation	1,633,364	1,336,822	22.2
Truscon Steel Co	1,767,731	1,330,389	32.9
Wheeling Steel Corporation	8,506,304	5,685,848	49.6

Net profits of rubber industry

	1941	1940	Increase, percent
Firestone Tire & Rubber Co. [1]	$11,262,428	$8,652,608	30.2
General Tire & Rubber Co. [2]	1,218,569	595,917	104.5
B. F. Goodrich Co	8,608,324	6,121,357	40.6
Goodyear Tire & Rubber Co	12,831,397	10,309,788	24.5
United States Rubber Co	13,662,658	11,425,241	19.6

[1] Data for years ending Oct. 31, 1940, and 1941.
[2] Data for years ending Nov. 30, 1940, and 1941.

Net profits of copper producers

	1941	1940	Increase (percent)
American Smelting & Refining Co	$15,742,662	$12,735,204	23.6
Anaconda Copper Mining Co. [1]	[2] 43,400,000	35,052,699	[2] 24.0
Calumet & Hecla Consolidated Copper Co	1,209,668	713,594	81.7
Consolidated Coppermines Corporation [1]	[2] 1,117,009	812,194	[2] 38.0
Kennecott Copper Corporation	49,251,857	43,837,329	12.4
Magma Copper Co	[2] 1,468,000	1,132,908	[2] 30.0
Phelps Dodge Corporation [1]	[2] 14,450,000	12,603,980	[2] 15.0

[1] Net income before allowance for depletion.
[2] Estimate.

Net profits of miscellaneous companies

	1941	1940	Increase, percent
Alpha Portland Cement Co	$1,325,672	$918,084	44.4
American Airlines, Inc	2,473,160	1,858,560	33.1
American Express Co	2,105,106	1,734,657	21.4
American Woolen Co., Inc	6,943,886	3,154,464	120.1
Baldwin Locomotive Works	3,975,409	1,944,073	104.5
Climax Molybdenum Co	8,054,104	6,039,373	48.3
International Harvester Corporation [1]	30,634,588	23,161,110	32.3
Newport News Ship Building & Dry Dock Co	5,291,373	4,383,176	20.7
New York Shipbuilding Corporation	3,074,533	2,334,261	31.7
Owens-Illinois Glass Co	9,040,148	7,223,034	25.2
Radio Corporation of America	10,102,716	9,113,156	11.8
Remington Arms Co., Inc	3,058,839	1,945,563	57.2
Savage Arms Co	3,426,029	1,028,401	233.2
Western Union Telegraph Co	7,366,240	3,621,581	103.4
Westinghouse Electric & Manufacturing Co	23,117,510	18,985,428	21.8

[1] Data for years ending Oct. 31, 1940 and 1941.

Mr. MARSH. In conclusion, I do not know whether the attention of the committee has been called to this full-page ad in the Washington Post of the Bethlehem Steel, what they have done, and so forth. Well, they have done it; they started rather late, about a year or so. Of course, it is not quite so large in the Washington News, the reason being the Washington News is not so large. There are two paid ads, one from United States Steel and one from Bethlehem Steel, in the same issue. While I don't know, I presume these corporations paid for these advertisements. You do not want me to read them in the record probably, but I should like to put them before you here for the information of the committee, and request this very sincerely, that you will see to it that such advertising is not deducted in avoidance of taxes as legitimate business.

Let me say this: I hope my suggestion will not result in cutting the salaries of any of the boys or girls on the Post and News, because I like them, but at the same time, if corporations are going into this page advertising, generally, it runs up in the hundreds of millions, and the Government is going to have that much less to tax.

My final request is that you take this short article, based on Government figures, Department of Commerce figures, entitled "War Increases Property's Cut of National Income," and also the one about the $60,000,000,000 of tax-free land. I took the reports, as far as I could get them, from the assessors, of municipal land values, the assessed valuation, and the Department of Agriculture issued figures showing that from 1940 to 1941 the selling price of farm lands, exclusive of all improvement, increased nearly $2,000,000,000. That is a big increase, largely due to Government-guaranteed prices and high prices. If I may read those two articles in, and you gentlemen will accept our recommendations, I will feel we are a long way toward getting essential democracy in taxation.

(The matter referred to is as follows:)

[From People's Lobby Bulletin, July 1942]

WAR INCREASES PROPERTY'S CUT OF NATIONAL INCOME

In 1941, recent figures of the Department of Commerce show, total compensation of employees (salaries and wages) was only 68.6 percent of the national income, compared with 76.7 percent in 1932.

The national income in 1941 was $94,540,000,000 compared with $39,912,000,000 in 1932.

The national income, after 9 years of New Deal deficiteering, was 237 percent of the national income the year the New Deal was elected.

Total compensation of employees in 1941 was $64,801,000,000, compared with $31,610,000,000 in 1932, but in 1932 "supplements to salaries and wages" (work-relief wages, social-security contributions, railroad retirement, and unemployment compensation contributions, and private pension payments) were only $643,000,000 and in 1941 were $3,638,000,000, or nearly six times as much.

Salaries and wages alone were $30,967,000,000 in 1932 and $61,163,000,000 in 1941—an increase of $30,196,000,000, or 97.4 percent, compared with the 137-percent increase in the national income.

The record of profits, net interest, dividends, net rents, and royalties during the fateful 9 years from the birth of the New Deal to Pearl Harbor is different.

ECONOMIC ROYALISM GROWS

From 1932 to 1941:

Net income of incorporated business increased from a loss of $3,646,000,000 to $7,206,000,000, by $10,752,000,000.

Business savings increased from a loss of $6,373,000,000 to $2,557,000,000, by $8,930,000,000.

Net income of unincorporated business increased from $4,849,000,000 to $14,642,000,000, by $9,793,000,000, or 202 percent.

Of unincorporated business net income:

1. Agricultural business increased from $1,488,000,000 to $6,160,000,000, by $4,464,000,000, or 301.4 percent.

2. Other business increased from $3,361,000,000 to $8,482,000,000, by $5,121,000,000, or 152.4 percent.

Net interest decreased from $5,628,000,000 in 1932 to $5,261,000,000 in 1941, by $367,000,000, or 6.5 percent.

Net interest payments in 1941 were, however, $151,000,000, or 3 percent larger than in 1933.

(NOTE.—The reduction in net interest receipts since 1932 is due to the reduction in interest rates, debt moratoriums, etc. The current enormous increase in the national debt, because Congress refuses to tax adequately, will, if maintained, bring total interest payments to between $6,500,000,000 and $6,750,000,000 in 2 or 3 years.)

Net rents and royalties increased from $1,471,000,000 in 1932 to $2,630,000,000 in 1941, by $1,159,000,000, or 78.8 percent.

The increase in net rents and royalties in the 9-year period was over three times as much as the decrease in net interest payments.

This is a natural result of lower interest rates, designed to benefit America basic economic royalists—speculators in land and other natural resources.

During this 9-year period covering the rise and fall of the New Deal income from ownership and control of property, as rent, interest, dividends, royalties, business savings, and entrepreneurial withdrawals increased from $8,945,000,000 in 1932 to $33,375,000,000 in 1941, an increase of $24,430,000,000, or 273 percent.

PROOF OF PUDDING

Since it is still true that the proof of the economic pudding is in the eating, and that the depression was largely due to the disproportionate share of the national income going to property owners, the following showing of Government figures is important:

From 1932 to 1941:	*Percent*
The national income increased	137.0
Salaries and wages increased	97.4
Income from ownership or control of property increased	273.0

Al of these increases are chiefly due not to sound economic and fiscal policies, but to charging the major part of the bill for pump-priming to the next generation, in accordance with current Harvard hallucinations and hysteria.

The Nation's present unsound economic condition, well known to the rulers of every nation under the sun, point to a career of financial imperialism for America exceeding the world's past records.

Certain factors in the situation should be recorded:

1. At least 9,000,000 more people were employed in 1941 than in 1932.

2. There was only a small increase from 1932 to 1941 in the number of people getting income from ownership or control of property.

3. About 20,000 people received approximately one-third of the $4,640,000,000 of net dividends paid in 1941, as of all dividends paid, amounting for the 9 years since 1932 to $34,137,000,000.

4. Wage earners will have to pay a large part of the increase in their average wage in taxes or in purchase of war bonds, with no assurance of employment when the war program is over.

5. The wealthy with incomes from property, although all incomes over $25,000 (with allowance for dependents) be taken in taxes, will, at the end of the war, own sources of their unearned income. The surpluses, reserves, and undivided profits of corporations are now about $48,000,000,000.

6. Our experience during the past 3 years, since we started the defense and war programs, shows the futility of increasing wages and prices for farm products to provide higher dividends, rents, royalties, interest payments, and entrepreneurial withdrawals—even though half or three-quarters of these property returns be taken in taxes.

This policy increases war costs, inflation dangers, and aggravates post-war problems at home and abroad.

To solidify the cement which binds the United Nations, to loosen quickly the cement which ties the Axis Nations, to reassure the peoples of neutral nations, and to unite the United States, America must adopt policies which will give producers the full value of what they produce.

[From People's Lobby Bulletin, July 1942]

$60,000,000,000 OF TAX-FREE LAND

The People's Lobby has asked Congress to tax the nearly $60,000,000,000 of tax-free city and farm land, with a small exemption for little home and farm owners.

The following are reasons for such a tax.

The full assessed value of taxable land in 32 American cities with a population of over 300,000, is about $19,500,000,000, and the total selling price of taxable land in all incorporated cities, towns, and villages, is about $35,000,000,000.

This assessed value is the net rent above taxes, that is the tax-free selling price of land.

There is a marked concentration of ownership of valuable land in every major American city, and most smaller ones, with tax-free selling prices up to a rate of nearly $3,000,000 an acre, in New York, Washington, and Chicago.

The Census Bureau reports the value of farm lands, exclusive of all buildings, as $23,236,000,000 early in 1940.

With higher prices for farm products in 1941, and Government payments to farmers of $766,000,000 that year, farm-land values in 1941 must have been at least $23,500,000,000.

The Department of Agriculture reports "Farm real-estate values for the country as a whole rose about 7 percent during the 12 months ended March 1, 1942."

FARM-LANDS VALUE JUMPS TWO BILLIONS IN YEAR

The value of farm buildings decreased during 1941, with little new construction, so the increase in the selling price of land from 1941 to 1942 was at least 8½ percent, or $1,998,000,000. The Department of Agriculture reports total farm real-estate values increase 10 percent in 12 farm States.

This farm bonus of $2,000,000,000 did not go to the Okies and the Odell Wallers of agriculture, but to economic royalist landowners, and their creditors.

In 1941 Government payments to farmers were $585,700,000, of which Texas got $63,600,000. 10.85 percent, or nearly one-ninth of the total, and six States—Illinois, Iowa, North Dakota, Kansas, Arkansas, and Texas—got almost exactly $217,000,000, 37 percent, or close to two-fifths.

In 1929 one-tenth of the farms got 41 percent of farm income; in 1939 they got 48 percent; and in 1941 nearly 50 percent—one-half.

The Department of Agriculture reports that in 1941 farm income, including Government payments, was $11,244,000,000, an increase in a year of $2,089,000,000, or practically the same amount as the increase in the value of farm lands from 1941 to 1942.

The Commerce Department reports that for 1941 the net income of agricultural unincorporated business was $6,160,000,000, or $3,936,000,000, almost 180 percent more than in 1933.

Most of this went to a fraction of farmers.

The Federal Government cannot constitutionally tax land values directly, though it can subsidize landowners directly, and has done so to the tune of many billions of dollars.

The Federal Government can, however, impose an excise tax on the privilege of holding land, based on the value thereof—with or without an exemption.

In view of general State and local sales taxes and other consumption taxes, which fall most heavily on small income workers everywhere, an exemption of $500 to $750 should be made, so no small city or farm home owner would be taxed on the occupancy or use of his own home or farm.

A 1-percent excise tax should be levied by the Federal Government on every landowner, based on the total value of his land holdings, with a small exemption.

Such an excise tax would check inflation at its source, yield $300,000,000 to $350,000,000 in revenue, enable the Government to acquire land for housing, encampments, proving grounds and other public purposes—at a much lower price than it is now paying, and stop speculation in land.

The Federal Government last year acquired about 4,000,000 acres of land chiefly for military purposes; within 5 years it will probably have to acquire several times as much.

UNFREEZING URBAN LAND

The recent discussion of the urban land problem by the National Resources Planning Board, under the caption "Unfreezing urban land," recognizes the role of taxation of land values.

"We have not realized adequately the power of taxation as a tool for the refashioning of cities, apart from the raising of revenue.

"Competent estimates suggest present nonfarm housing needs of well over 4,000,000 units. * * * To come abreast of our needs by 1950, would call for an average annual production of over 1,100,000 dwelling units.

"We must make urban land fluid again.

"This basic planning concept will reveal the importance of freezing urban land from the burden of other fixed claims (mortgage burdens, etc.) against it, which in effect sterilize it. * * *

"A century of laissez faire has left us with claims against the land, which, if they are to be recognized as valid, will keep the land frozen, because they are based upon conceptions of the value (selling price) of land which no longer seem supportable."

Asserting "there is little hope that cities can recognize these claims and buy up the land for rebuilding without aid," the Board comments that if the Federal Government aids, the question will be asked—"Should we bail out the owners?"

"Following its questions—Is the owner of an obsolete structure to be paid values which should long since have been amortized when the structure as it stands may violate half a dozen laws?", and whether local or Federal taxpayers should foot the bill—the Board quotes Winston Churchill—"If we bring up the past to quarrel with the present, we may lose the future."

A more realistic view is—if we make exploitation in the past a burden upon the present and the future, neither is secure—even if we call it "private enterprise"!

Mr. MARSH. You realize I have not suggested any sales tax. I know you have got to have a withholding tax, I realize that, and that is part of the mechanism, it seems to me, of an income tax, but I believe you will agree since 7 percent of our workers gets less than $10 and another 7 percent gets between $10 and $20, that no kind of a sales tax can fail to hit those folks too hard. Do not put on the sales tax just because it is going to take courage to reduce the exemptions.

I thank you for your courtesy, and I am going to discuss this subject from here to the coast starting in a few weeks. Let me repeat, if you think that I am making any bizarre suggestions you can get Gallup to make a poll of the boys in uniform, the draftees and the boys that are about to be inducted. I am inclined to think they will

agree with the position I have taken. If there are any questions I would be glad to answer them.

The CHAIRMAN. Are there any questions?

(No response.)

Mr. MARSH. I appreciate this unanimous agreement.

(The ads referred to were filed with the clerk of the committee.)

The CHAIRMAN. Mr. Julian Goldman.

STATEMENT OF JULIAN GOLDMAN, PRESIDENT, GOLDMAN STORES CORPORATION, NEW YORK, N. Y.

Mr. GOLDMAN. Mr. Chairman and members of the committee, about a year ago I recognized that inflation could become as formidable an enemy to the interests of our Nation as Hitler and his colleagues, and since then I have devoted myself to a relentless campaign to arouse the public as well as the Government to the need of using every possible means to curb inflation. As a result, I was responsible last fall for the formation of the National Committee to Keep Prices Down, a nonprofit organization, and on whose advisory board were some very eminent economists teaching at important eastern universities.

We asked for membership of manufacturers, distributors, and retailers, all pledged to do their utmost to help keep prices down. Our statement of principles included most of the program that was outlined by the President on April 27, except that we also stressed the importance of compulsory saving.

It has been my firm belief from the very outset that unless compulsory saving is adopted, all that is being done to stem inflation will prove to be futile. I stated so in a message that I sent to the President a few days before he made his announcement on April 27. I spent 2 weeks during the early part of April visiting important and small cities throughout the Midwest, speaking to local groups and over local radio stations, urging their cooperation to stem inflation and asking especially for the adoption of compulsory saving, and explaining just what it would mean to them.

It was most amazing to me how quickly the people grasped the importance of siphoning off the surplus purchasing power of the consumers through the means of compulsory saving, and how many of them indicated a readiness and eagerness for the adoption of this plan.

So much has already been said about the dangers of inflation and how necessary it is for us to fight this war on the economic front as well as on the battle front, that I will refrain from any further comments on that score.

You gentlemen of the Finance Committee of the Senate are now faced with as great a responsibility as any group of men ever faced in the history of our Nation.

It was only 25 years ago that we fought a war to end all wars, and today we are engaged in a bloodier, more titanic struggle to prevent the enslavement of mankind and to preserve what we know as the American way of life. We are all agreed that given in sufficient quantity the tools of war, the men to use them and the brains to guide them, and a spirit dedicated to the Nation rather than to the individual, that we shall win this war.

The people, however, are also interested in learning that when the conqueror has been smashed and when free people everywhere have been liberated, will we then still have the privilege of living according to what we now know as the American way of life?

The Secretary of the Treasury in a statement made to this committee on July 23, stated:

> Inflation has been well described as "the ruthless process whereby sacrifice is imposed inequitably upon a people who have lacked the unity, the courage, and intelligence to impose that sacrifice equitably upon themselves." It is for us to show that we have the unity, the courage, and the intelligence to check inflation now.

If that is true, and I heartily agree with him, why does not the Secretary of the Treasury, and why should not this committee face the issue of inflation by recognizing that this present tax bill will not serve the purpose of stemming inflation, nor either does it outline any sound plan for financing the war.

Gathering from the figures as presented by the Secretary of the Treasury, he will have to borrow in excess of $50,000,000,000 for this fiscal year. The present program for the voluntary purchase of bonds, if successful, can only amount to about $12,000,000,000. In order to sell these bonds we practically have to go around with hat in hand, begging and imploring people to buy them, and there still remains a deficit in excess of $35,000,000,000. The Treasury contemplates solving this problem by selling this staggering amount of bonds to the banks.

Inasmuch as we fall short of the $12,000,000,000 that the Treasury claims will be sold to the public through the voluntary plan, so much greater will be the sum that the banks will have to take care of.

All indications point now to the fact that the voluntary campaign will not be fully successful, and that therefore much more than the $35,000,000,000 of bonds will in consequence be taken by the banks, who, of course, do not have to pay for them, but have only to write up a deposit on their books.

This is a positive step toward inflation. All that the Office of Price Administration will do, plus all of the efforts of the President, will not be able to stop inflation if you permit the Treasury Department to continue to sell this tremendous amount of bonds to the banks.

There is not much difference in the primary effect of selling such a volume of securities to the banks than in an outright printing of the money.

Notwithstanding the fact that with all the restrictions that have been placed, and the price ceilings that have been invoked, inflationary trends are appearing everywhere. "Black markets" are being created. It is only a matter of a short time when we will have the lawlessness in this country, unless something is done immediate to siphon off this extra purchasing power, that will be similar to what we experienced during the days of prohibition.

The American people love their country. I doubt if any group of people would fight more to preserve what America stands for than our people will. However, I am moved to wonder where selfishness stops and where patriotism begins. I am prompted to make that statement because of the hoarding that was done, not only by consumers but by manufacturers, distributors, and retailers throughout the past year in

order to serve their own selfish interests. War always produces human vultures. This war has proven to be no exception. Given the opportunity, there are always some people who trade on patriotism, on misery, even on death, to make a dollar. I am fearful that only when some huge catastrophe rocks their very foundations will these selfish people realize how serious the situation is, and how little, if anything, they are contributing toward saving our American way of life and preserving the freedom we so deeply love and cherish.

Therefore, I respectfully state it is your responsibility, as important members of our Government, to siphon off this extra purchasing power that the consumers have so they will not be tempted to hoard and they will be in no position to patronize "black markets."

Mr. Henderson states that he believes that sum should be about $17,000,000,000. I think his estimate is too conservative. The amount that should be siphoned off is about 25 to 30 billion dollars, and it can only be done through compulsory saving.

The present bill has a withholding tax providing for the impounding of 5 percent of all salaries commencing next January 1 as advance payment on income tax due in 1944.

There are certain facts that you gentlemen must seriously consider. Knowing how closely you are observing the industrial situation, you will recognize how true are the facts that I now present.

Millions of men have been thrown out of regular employment because of priorities. Some men who used to earn $100 a week are now compelled to take other jobs where their salaries are half of what they were formerly. On the other hand, men and women who were formerly out of work are now making large salaries, entirely out of proportion to their normal earning ability. I know of specific cases where men who earned $100 a week regularly find it difficult to obtain employment, while third- and fourth-class mechanics who never could find work are earning $100 per week and more.

In my opinion it is not equitable to increase the tax on this former group of employees and then to burden them additionally by withholding payment for advance taxes, while on the other hand the tax upon the workers who are now getting fat pay envelopes is not at all sufficient.

It is important in order to win this war to build up the morale of the people. I have encountered hundreds of men whose salaries have not been increased during the last few years, and who have had to meet the soaring cost of living with their same salaries, and now you want to tax them in the same manner that you tax the people who are benefiting by the extraordinary wages that are being earned in defense industries. I have been in towns where there are no defense plants; where there are vacant apartments; where a great percentage of the population have wandered off to defense towns; where many people are still out of work or earning as much or less than they did formerly.

Is it equitable to ask the people in these towns to pay the same tax created because of the war as you would those who have tremendously increased their earning power because of the war? We can straighten out these inequities through the means of compulsory saving. I strongly urge the withdrawal of the withholding tax from the present bill. Instead, let us use compulsory saving to siphon off more from those who are earning more and little or nothing at all from those who are earning less or not any more than they did previously.

If a person is earning $100 a week now and formerly earned only $30 and that increase was due only to defense work, why should not such an individual be compelled to apply $35 out of his weekly salary for the purchase of war bonds? It is not fair to add burdens to such families who are now living on a below-minimum standard, while others are on a spending orgy due to the fact that they are earning more money now than they ever did in their entire lives, and relatively will not feel the effects of the new proposed taxes.

Young lads and young girls are earning $40, $50, and $60 a week in defense plants, while married men in nondefense towns are earning $20 to $30 per week. I propose a plan of compulsory saving that will especially affect those people whose salaries have been increased because of the war, and also a plan for those whose salaries are sufficiently large to enable them to purchase bonds.

I would meet this situation by having a board of appeals set up the same as ration boards are now, to which persons could appeal to be given relief where compulsory saving would create a below-minimum standard of living for them. I would suggest that the individual be paid in scrip for that percentage of the salary and other income that should be utilized for compulsory saving, and then the scrip can be traded for the purchase of bonds which could not be cashed or liquidated until after the war.

By this plan we would be able to withdraw about 25 to 30 billion dollars of the national income for immediate use by civilians. We would, therefore, be postponing the spending of this huge sum until the war is over, at which time this buying power will be very helpful and most necessary to keep the wheels of industry turning during that difficult period of readjustment. When the war is over, the Government could then decide in what manner these bonds could be cashed and thus control their redemption and in that way properly guide the movement to build up industry again.

The use of compulsory saving is not only a great defense measure for controlling inflation, but it will give us added faith to look to the future, knowing that its use will be a cushion to absorb the shock during the uncertain post-war period.

I am in the retail business and have been all my life. My efforts to curb inflation have painfully hurt my own interests. The adoption of compulsory saving, withdrawing so much additional spending power from the consumer means that my own interests will be further affected. I have been told that it is unbelievable that a man would campaign against his own personal interests. Nevertheless, I am hurt because I am so strong in my conviction that there is nothing that I can do that will so much protect the interests of our people during this great crisis than to fight for the prevention of inflation, and the adoption of compulsory saving which can make that possible.

I conclude by reminding you that we give comfort to the enemy when we take complacent action in warding off the perils of inflation. Inflation is as insidious as saboteurs, spies, and fifth columnists. Once its poison has spread throughout our economic system, its ravages are hard to cure. Inflation causes national disunity and it lowers morale. Moreover, we owe it to our youth to maintain at home the very standards they are fighting for on battlefields the world over. Whoever of us seeks now to advance his own selfish interests, will be responsible for the senseless slaughter of our soldiers. Can we with any decency

ask the soldier to give the last full measure of devotion to the freedom, safety, and comfort of those of us who are not ready, nay eager, to make every sacrifice for the common cause?

It is with these words that I ask you gentlemen to meet the issues that confront you courageously and boldly.

I am informed that the Secretary of the Treasury stated before you gentlemen the other day that sales of War bonds must be left for the present on a voluntary basis certainly until the end of the year, adding that if he would change his mind he would come back to the committee and admit his error.

There are more than 5 months between now and the first of the year. Tremendous damage can be done during that period of time. The seeds of inflation will have sprouted during those 5 months. Gentlemen, this is no time for temporizing or pussyfooting. I doubt whether there is any competent economist, of whatever political attitude, who will not favor compulsory saving as requisite in this situation. It is not undemocratic to conscript the lives and the services of our young men for the Army, the Navy, and the Air Force. Why should it be undemocratic to conscript the dollars, or merely a loan of them, from the people, particularly those who are benefiting from this terrible catastrophe?

Thank you.

Senator VANDENBERG. Mr. Goldman, in dealing with that phase of your discussion, which I think very correctly emphasizes the disparity in earnings between different groups of our people, would not it partially meet your objective if we were to apply the principle of the excess-profits tax to individual incomes?

Mr. GOLDMAN. I think it would serve the purpose of removing that inequity, but that would not stem inflation.

Senator VANDENBERG. No, no.

Mr. GOLDMAN. I mean that would serve that purpose; yes. I am only submitting facts that are in my mind, or have been for the past year. There are these inequities that you gentlemen must consider, because I have been face to face with them. I have talked to men, men even in Federal service. I am a distributing agent for the Federal Government—I mean in selling bonds. In the General Electric at Schenectady they have a checking system whereby every check is stamped "Not over $100." You know they have to pay two checks to thousands of their employees because they are getting salaries over $100 a week, men who never made over $25 formerly. Such people have ample money today, and they are the people who could help us finance the war. It is through using the means that I suggest that you would help to stem inflation. Before the President made the statement on April 27th I sent him a message stating we would not stem inflation unless compulsory saving is adopted, even if you stopped the raising of wages, because you still will have a surplus of twenty-five to thirty billion dollars every year as long as the war lasts.

Senator TAFT. Mr. Goldman, I agree that the compulsory savings is better than taxes to take up this increase in wages from what a man had last year to this year, but what bothers me is how you are going to determine that increase, how difficult it is going to be to go back to last year's income. Of course, where a person has filed an income tax return last year and this year, it is fairly easy, but many of these people have come from the country where there was no record at all. Also,

of course, their expenses have in some cases increased. When they lived in the country, they had no expenses. Now, they go to town and they have fairly heavy living expenses. It is the machinery. I thoroughly agree with the principle of the thing. The thing that worries me is the machinery by which you will work that out. That, I think, is what worries the Treasury, as I got it the other day when the question was raised about a tax on this basis.

Mr. GOLDMAN. Senator Taft, I read in the papers the other day that you were in agreement on that plan, and I have given considerable thought to that very question. We seem to be able to solve the problems of gas rationing in the East which is a rather complicated problem.

The CHAIRMAN. I wouldn't say they were solved.

Mr. GOLDMAN. We are trying to solve them, anyway, and they are being solved.

The CHAIRMAN. You are a great optimist if you think they have been solved at all.

Mr. GOLDMAN. You would be amazed as to how many people are reconciled to the fact that if it has got to be done, they are going to do it. It isn't simple to do these things. They are rather revolutionary. The phase that Senator Taft brings up is important from that angle. When a man earns $35 a week and he now makes $100, and if you only siphon off $35, you are giving him enough money to take care of the extra expenses he has. If you are going to go into the withholding tax process, which is one of the most burdensome things that you have to encounter, and you also go into the income tax situation, you put people on their honor, where if you write the right kind of bill, they will try or they have got to be made to try to tell the truth and tell the facts. They know how much they made last year, and I believe there are hundreds of thousands of patriotic people in this country who would like to be on boards to supervise this work—just the same as you have draft boards and ration boards—who would love to have an opportunity to do some of that work in this country and which I think would meet the situation. I am sure, gentlemen, if we sat down around the table and gave this matter the thought and attention it needs, that we can solve this problem. I pledge my word to you now—and I have given this matter a year's thought—that unless you have compulsory savings, you will not stem inflation. I predict that. There is no man who loves his country any more than I do, and as I told you in the statement, it is prejudicial to my own interests and destructive to them, but I prefer to be destroyed because of a principle that I know means so much to our country. I went through 1921 and I saw what happened, and that is what we will go through again after this war is over. After we have fought and won, then what? At least we can try to salvage the situation to such an extent that when the war is over we will have something to look forward to.

Think of all the bonds accumulated because of compulsory saving that will be available in the future. Do you know what is going to happen, Senator George? If you don't have compulsory savings, here is what is going to happen to the $90,000,000,000 that is available for spending today. The people will use the $90,000,000,000 to buy $60,000,000,000 worth of goods and throw the $30,000,000,000 out of

the window. Why not use the $30,000,000,000 to beat the Axis? Why not save it for future buying power when the war is over?

You are not going to stop black markets; you know you can't. If people want things and their pockets are bulging with money, they are going to buy them.

I wonder where selfishness stops and where patriotism begins. You saw the hoarding that went on during the last year. You even saw manufacturers and distributors doing it, each one trying to serve their own selfish interests. I mean it may sound harsh for me to say that, but do you know that the newspapers refused to print that part of my statement as I went around the country, and the Milwaukee Journal was the first that had the courage to print that phase of it. They are facts, and we must meet them. You will not stop inflation, gentlemen, unless you siphon off that purchasing power, and you are not going to tax the people an additional $30,000,000,000 unless you do it as Senator Vandenberg says, by excess-profits taxes and take all their money back from them who have made this extra money, and then you will destroy initiative. Under compulsory saving the Government can decide when they should cash the bonds. They should control the cashing or liquidating of them and then let it help turn the wheels of industry when the war is over.

How many people are alarmed today, worrying about what is going to happen when the war is over, from the economic and industrial standpoint? This is the contribution we can make now, and the people who are benefiting from this catastrophe must do their share.

If I never do another thing in my life, I am glad of the opportunity to present these facts to you because I know how keenly interested you are in this particular subject.

The CHAIRMAN. Thank you very much, Mr. Goldman.

(Mr. Goldman submitted the following supplemental statement:)

SUPPLEMENTAL STATEMENT BY JULIAN GOLDMAN, PRESIDENT, GOLDMAN STORES CORPORATION, NEW YORK, N. Y.

Mr. Chairman and members of the Senate Finance Committee: I make this supplemental statement in addition to the one I made before you gentlemen on July 28 because I promised Senator George that I would make some specific recommendations in connection with my suggestion for the adoption of compulsory saving.

I have been reading with great interest the reports of the testimony that has been presented to the Senate Finance Committee during the past few weeks. Though everyone who has appeared before you seems to feel that the suggestions he presents is of utmost importance, I have no hesitancy in saying that there are really only two outstanding problems that confront you.

One is how to finance this war and the other is how to finance it so that it will prevent a run-away inflation. One depends upon the other, they are so correlated. If you have a run-away inflation, then the cost of the war will increase to the extent of the inflation. There is one fact that is certain. You cannot hope to finance this war without a specific plan. I am reluctant to make the following statement, but nevertheless it seems true. The Secretary of the Treasury has no specific plan for financing the war, or as yet has not presented one. I could almost characterize his attitude as one of "trusting to luck" that it will all come out all right.

The Office of War Information announced that $205,000,000,000 has been appropriated thus far for the war program" but although they have been long on appropriations, they have been perilously short on planning. There has been tremendous plant expansion and now we have too many factories for the moment, but not a sufficient amount of raw materials is available to operate these factories, on a full schedule. There may be an excuse for such unfortunate planning because it was all done hurriedly and under great

pressure, but there is no excuse for our not planning properly for the financing of the war, which is as important a task as supplying the tools of war. We may not be able to control our destiny on the high seas or on far-flung battlefields at the moment, although we have no doubt that eventually we will prevail, but we do have the opportunity of controlling the financing of this war, and, gentlemen, that is the responsibility that is confronting you now.

Never in the pages of history can we find where a Senate Finance Committee was confronted with such a titanic responsibility as is presented to you at the present time: $77,000,000,000 is the Federal Budget for this fiscal year. Whether this present revenue bill will raise six or eight billion dollars in tax is relatively unimportant, as compared to the main issue.

The Secretary of the Treasury has to borrow approximately $50,000,000,000 for the fiscal year. Presupposing that he does raise the $12,000,000,000 by the voluntary purchase of bonds, there is still in excess of $35,000,000,000 worth of bonds to be sold. Here are some important figures as they present themselves to me.

The net national income, after all taxes have been paid, available for spending purposes, will be about $90 000,000,000. The public will only be able to spend about $60,000,000,000 because the Government is taking the rest for war purposes. The public will thus have an excess buying power of approximately $30,000,000,000.

The task that confronts you, gentlemen, is to find the means to siphon off into the Treasury that share of private income which will take up this slack and reduce the buying power of the public to the amount of goods that is available to be bought. If this is done, the recipients of income will then have for expenditure no more and no less money than will cover the purchase of the goods available to them without any increase in prices. If this is not done (and the public must be acquainted with that fact) they will get no more goods, but instead they will "pay through the nose" for them.

Instead of saving the $30,000,000,000 and helping to finance the war, they will be squandering this sum, bidding against each other to purchase the goods that is available. Remember that although you have fixed prices nevertheless the people will squander this $30,000,000,000 by supporting black markets or because the price level will be forced upward. In other words, my plan is to postpone the consumption of $30,000,000,000 worth of commodities until after the war. The more we reduce the present consumption in this way, the larger will be the backlog of available purchasing power with which we can meet a post-war slump, and help start properly the wheels of industry at that time.

To meet this situation I recommend the following amendment to this proposed revenue act. That we tax, "as an emergency measure," 15 percent of every individual's taxable income of 1942, and permit the payment of that tax by the purchase of nonnegotiable War bonds which cannot be cashed or be used as collateral for loans during the duration of the war. They shall be subject to call by the Government after the war at such time as the Government would deem it advisable to do so. They shall carry the same rate of interest as regular War bonds.

In view of the fact that the tax return for 1942 will not be made until March 15 of next year, I therefore would incorporate in that amendment that in order to liquidate that tax, these special War bonds must be purchased before the end of this current year. In that manner we will immediately start to syphon off this surplus purchasing power, and awaken the people to the fact that they must, in a greater measure, help finance the cost of this war.

If we really had the courage, Congress should immediately legislate that 30 percent of all taxable income should be utilized for the purchase of these special bonds. There should be no let-down in the effort to sell the present War bonds because there will still be a substantial sum that will have to be sold to the banks.

Notwithstanding the adoption of this recommendation, we will still have a moderate form of inflation because this special tax will amount to about ten to fifteen billion dollars. Thus the Secretary of the Treasury will have to sell many billions of dollars of bonds to the banks, and the public will still be supplied with a surplus buying power. The intent is to get the people accustomed to the compulsory saving now, and the objective is that within the next year, the amount deducted from taxable income will be increased to such an

extent that eventually the entire surplus buying power will be syphoned off, and all of it will be utilized for financing the war, thus reducing to a very small amount the bonds that will be sold on the voluntary plan.

I urge the withdrawal of the present withholding tax from the bill and instead suggest that we depend more upon the increased amount of compulsory saving to finance the war than to further increase the tax burden for the present.

When I first appeared before you, I outlined the inequities that were existent in the earning power of the American people because of the war. I noted that Senator Taft was very sympathetic with the proposal for compulsory saving, and for the removal of such inequalities, if the machinery could be developed to accomplish that purpose. Senator George, you also indicated an interest in that direction. I believe that Senator Vandenberg feels likewise. I have been struggling with that problem since I have seen you, gentlemen, but my efforts have been futile.

The machinery to accomplish that purpose is too complicated, and I am convinced it would be unwise to invoke any regulations that require such complicated machinery at the present time. However, my conscience seems to be more at ease since I have gone deeply into that subject. I do not seem to be so much disturbed over the fact that some people are making so much more money because of the war, and others have had their income reduced. Possibly they are entitled to it. We cannot all have it sweet and to our liking all the time. Others who have been working part time and who have been out of work, are now enjoying prosperity, but they previously endured a long stretch of tough sledding.

I have also become convinced, and I am frank enough to say to you gentlemen present, that we must not indulge in frustration because of too high a regard for equity. There is, in any event, no equity in war, and it ill behooves any of us to complain of any taxes or of compulsory saving, when great numbers of us will be called upon to make the supreme sacrifice.

There is one fact that must be borne soundly in our minds. The human being has not reached the height where he can impose upon himself the sacrifices that are vitally essential for winning this war. To be utterly frank, I know that you, too, have met very few who really recognize how much of a sacrifice they should and must make in order to insure the winning of the war. The hoarding that was practiced during the past year most convincingly confirms that fact. It is therefore your responsibility, gentlemen, to impose those hardships upon the people that they will not impose upon themselves, and to do it in such a practical and sound manner as to insure the proper financing of this war, and to prevent simultaneously any substantial rising tide of inflation.

The recommendation that I make is a mild one in comparison with what is really needed. The people throughout the land are beginning to recognize that compulsory saving is the only proper medium for financing the war. If the people have a better understanding of what part they must play in financing this war, you would be agreeably surprised at the splendid cooperation that you will receive from them.

I lack words to impress upon you the urgency of your recognizing that compulsory saving is the only sound medium for financing this war. I realize that the Secretary of the Treasury is not enthused about it but, he too, will soon see the light.

It has been my great privilege to enjoy the friendship of our illustrious President for almost 20 years. I sent to him a copy of the first statement that I made to you gentlemen and I am also sending him a copy of this supplement. Knowing his unusual ability to read the people's minds, and in most instances to do the right thing, I am positive that he, too, will recognize the advisability of the adoption of compulsory saving for the financing of this war.

I noted in the newspapers the other day that Senator Connolly stated that preferred to sell $12,000,000,000 worth of bonds on a voluntary plan, than $12,000,000,000 worth on a compulsory plan. Senator, this is not a matter of preference or choice any longer. It is not what we would like to do, but what we must do. The Treasury is finding it difficult enough to sell $12,000,000,000 worth of bonds on a voluntary plan, but even if it succeeds, it does not solve our problem.

A festering wound needs radical treatment at the hands of a competent surgeon. To poultice such a wound is a dangerous treatment. A competent physician will advocate lancing it, no matter how painful the process may be. Inflation is a

dangerous festering wound, menacing the welfare of our entire economy, as well as our people, and needs radical treatment at the hands of competent men like yourselves.

I conclude by reminding you that we are fighting for our security. On battlefields and waters the world over, our men and boys, in company with sons of other free nations, are facing and meeting death so that our security will not be taken away from us.

What do we mean by "security"? Beyond those sacred principles inscribed in our Bill of Rights and the essence of the Four Freedoms affirmed not so long ago by our President, security means a job, a home, food, clothing, our entertainment, our savings accounts, our life insurance. In other words, to us security means peace of mind.

Will we have peace of mind—security—after we have made armless and harmless the Nazi, the Fascist, and the Jap?

Unless we curtail inflation now, there will be no security and there will be no peace of mind after we have won the war. Unless we battle with determination against it now, we shall be reduced to economic slavery when inflation engulfs the United States. Remember, above all, that our savings accounts and our life insurance, which every American family struggles to accumulate and protect, will practically become valueless unless we stop the runaway inflation that is confronting us. The adoption of compulsory saving is the solution!

The CHAIRMAN. Mr. Nixon.

(No response.)

The CHAIRMAN. Mr. Maurice Safley.

STATEMENT OF MAURICE SAFLEY, WILTON JUNCTION, IOWA

Mr. SAFLEY. Mr. Chairman, I wish to incorporate this in the record.

The CHAIRMAN. Is it a general statement, or is it dealing specifically with something?

Mr. SAFLEY. It is a banking bill turning the revenue over to the Government.

The CHAIRMAN. All right, sir, you may put it in the record.

(The following statement was submitted by Mr. Safley.)

Within the past decade there has been an increasing number of public-spirited citizens who have demanded a reversal of form in our monetary system. We cannot question the patriotism and sincerity of these good people. They are to be highly commended, not for what they may propose, but for the great interest shown in a problem that today is of utmost importance to everyone. Practically all of these monetary reformers are strongly opposed to that type of medium of exchange that consists of credit based upon debt—or just plain bank credit. Evidently these monetary reformers failed to realize that the only kind of medium of exchange that can be kept under control when issued in sufficient amounts to carry on normal trade is bank credit. Failure to keep our medium of exchange under control would cause this Nation to suffer its worst disaster in history. Not only is bank credit convenient and capable of being controlled, but it also possesses that essential characteristic of being elastic. Society would, no doubt, greatly benefit if this control could be made still stronger and the medium of exchange be made more elastic.

Practically everyone realizes by now that there is something radically wrong with our economic system. People are at a complete loss to understand why we have want in a land of plenty. It is highly impossible to solve our economic problems without first solving the problem of finance.

These monetary reformers, radical as they may be, are no more dangerous than the conservatives who merely murmur laissez-faire. Failure to solve our economic problems will in time have the same effect upon the Nation as an uncontrolled currency inflation. National bankruptcy may not be eminent, but it is very possible where there is a tremendous national debt combined with unemployment on a vast scale and exorbitant taxes on all earned incomes.

It has been repeatedly said that there are only about four or five people throughout the world who understand moneys and credits. I feel that I am

safe in saying there is no one. I have made a careful study of moneys and credits for the pst 15 years, and I frankly admit there is a lot I do not know. The more one studies this subject the more complicated the whole affair becomes. Perhaps the reason why we know so little about this all-important problem is because we have not only failed to inform our youth, but we have discouraged them as well. If one desires to discuss monetary reforms today, he is called a radical. It appears to be a rather poor policy on our part to deliberately keep our youth in the dark on this all-important issue when we know it is the young generation who has to face the mounting problems of tomorrow.

If we feel that the problem of moneys and credits is beyond our intelligence, then we are forced to admit a great weakness. The American people have performed almost miracles in most branches of learning. Whenever we encourage our youth to make an all-out study of finance, no doubt some great improvement will be performed along that line as well.

Before one contemplates making drastic changes in our financial structure it is highly essential that one is thoroughly familiar with various proven economic laws. Economics is a subject that is closely associated with moneys and credits. It is just as necessary for the financial adviser to abide by proven economic laws as it is for the engineer to abide by proven mathematical laws. Utter disregard for these fundamental laws will not only keep the Nation, but the whole world, in constant turmoil.

The oldest, simplest, and perhaps the most important economic law is the law of production. This law is so simple that one may gain the impression that it is not important. According to this law of production there cannot be a direct increase from a source that either cannot or does not produce directly. For instance, if one does not or cannot produce any service, he is not entitled to any direct increase in the form of wages. The four material elements of value that make up the universe are land, wealth, man's service, and moneys and credits. Rent is the direct increase from land. Profits are the direct increase from wealth. Salaries, wages, and commissions are the direct increase from man's service. Interest is the direct increase from moneys and credits.

Aristotle gave to the world a famous dictum that was law for almost 2,000 years. It was: "Money is barren and cannot increase at interest." Modern economics, however, contends that money is productive and can increase at interest. Aristotle based his law on the fact that one can neither eat nor wear money, and money possesses neither sex or seed. The economists advance the theory that with money one can purchase land and from land one can receive rent. Since one is justified in receiving rent, they are of the opinion that one is justified in receiving interest. Here we find we have two entirely different schools of thought. The former, however, is based upon facts while the latter is based on theory. We know that if a source is not barren it is either productive or indirectly productive. Money is not barren nor is it productive; therefore, it must be indirectly productive. So not only did Aristotle err by saying money is barren, but economists erred as well by saying that money is productive. The economists, being naturally quick to detect Aristotle's error, were able to set up their own theory contrary to a great law. Rent can be considered either the direct increase from land that is capable of producing directly or the indirect increase from money that it took to purchase the land. Money, being only capable of producing indirectly, can only enjoy an indirect increase in the form of rent or profit and no direct increase in the form of interest. Interest is fundamentally unsound as it is the direct increase from a source that cannot produce directly. By placing a direct increase upon a source that cannot produce directly, we are forced to deny certain members of society something that rightfully belongs to them.

I wish to quote Francis Bacon, a noted English economist, who said: "Interest is the means whereby the treasury of the realm soon congregates in the hands of a few." Anyone who has made a careful investigation of the financial ratings of some of our large insurance companies and credit institutions will have to agree with this great man's philosophy. Selden, a noted English statesman in the House of Parliament, made this famous statement: "If a stranger should come to this universe and find that the court upheld interest taking, and the pulpit denounced it, he would be at a great loss to understand." The early Romans looked upon interest taking to be as bad as murder. During the Middle Ages interest taking was absolutely forbidden.

We find that both the Old and the New Testaments bitterly denounce usury. According to the historians, the ancient word "usury" has within recent years

been changed to the modern word "interest," and all excessive interest is called "usury." There is no appreciative difference between the rate of interest of today over the rate of usury of ancient times. We cannot right an evil practice by merely changing the name. If this were possible, we could render the world a great service by changing the name of nazi-ism.

I have never condemned interest because of the direct effect it may have on the producer who operates on borrowed capital, but rather from the indirect effect it has on the consumer. Interest is considered a legitimate expense in the cost of production. This major expense in the cost of production greatly increases the cost of a finished product. The high cost of living can be credited to the high productive cost. By increasing the cost of living we, in turn, lower the standard of living. Interest is merely shifted on to the consumer by the marginal producer. It is to be remembered that interest does not grow on trees, nor does it drop from the heavens above. It originates from one source only—the hard-earned savings of the consumer. This hidden expense or indirect interest on all consumable goods accounts for the reason why the cost of living is out of line with the average family income.

Interest also comes in direct competition with labor, as interest must be paid before labor can be employed, or the products of labor consumed.

However, the main objection to interest is that capital prefers to invest its savings in interest-bearing bonds and mortgages rather than into productive enterprise where there is much competition, risk, toil, and taxes. By having capital refrain from engaging in productive enterprise, we produce less consumable goods and employ less labor. If capital could no longer receive interest, they would, if they desired an increase, have to invest their savings into productive enterprise. By having capital engage in productive enterprise, we would have more consumable goods to enjoy, and more employment.

Unemployment on a vast scale will prove disastrous for the marginal producer unless the Government, of course, intervenes. This costly intervention on the part of the Government can only temporarily serve to prolong the inevitable crash. If we are to retain our cherished capitalistic system, many private industries must spring forth to take care of the unemployment situation.

Let us consider interest from an international angle. Our high protective tariff has never been welcomed by the foreign nations. No nation of limited resources can maintain a high standard of living for its people when another nation, rich in resources, is in a position to impose a high tariff. Unfair trade relations is perhaps one of the best contributions we can make to the would-be dictators, as it gives them an opportunity to come into power. Many of our diplomats and economists favor the repeal of the tariff for the purpose of gaining the good will of our foreign neighbors. We must look upon the tariff as a result of a cause. The proper procedure is to eliminate the cause. Practically all of our producers who are protected by the tariff operate on borrowed money. On this borrowed money much interest is paid. We find that the cost of labor in this country is high because of the high cost of living. This interest—coupled with the high cost of labor—makes the tariff essential. To abolish the tariff without first abolishing the cause would be a great moral wrong committed against our honest producers. When we eliminate interest we can then eliminate the tariff without causing repercussions here at home.

The question arises as to why interest is paid to capital. Perhaps the best known reason is given by Richard E. Ely, a noted English economist. Mr. Ely states that capital will not depart with their savings unless they receive some compensation in the form of interest, due to risk and delay. Mr. Ely, we note, was very careful to stress the word "savings," but completely failed to mention manufactured bank credit. Certainly Mr. Ely was aware of the fact that the bulk of interest that goes to capital does not come from individual savings, but rather from manufactured bank credit. No doubt, Mr. Ely was of the opinion that only a few select members of society could enjoy this special privilege of manufactured bank credit. Mr. Ely evidently did not realize that society as a whole could install a banking system of its own, capable of completely eliminating capital from making loans. If capital were no longer called upon to depart with its savings and its bank credit that it has been allowed to manufacture, capital would no longer suffer from either risk or delay in making loans, thus interest to capital would no longer exist.

The economists of the school of Locke, Hume, and Adam Smith asserted that money is the fruit of labor, and that the possessors are entitled to compensation for its use. It is to be conceded that money is the fruit of labor, but that does not

necessarily mean that this fruit is productive. In fact, it is so easy to prove that money is not productive. These economists, like Mr. Ely, stress savings, but neglected to mention manufactured bank credit. Are we to consider manufactured bank credit a fruit of labor or a fruit of power? If we are to consider it to be a fruit of power, that fruit should no longer exist. It all simmers down to whether society as a whole or a few privileged members are to exercise the power of manufactured bank credit. If this power is vested in the hands of a few, then naturally society must compensate dearly for the use of this credit.

The general consensus of opinion among the modern economists is that interest is a just reward for saving. The only people who benefit from saving are those who do the actual saving. As a general rule, we receive a reward for services rendered to others and not to ourselves. From the time of the last depression to the present war the economists have gone all-out pleading with the people and the Government to spend. They were sincere in the belief that spending would serve as a means of recovery. Yet these same economists argue that interest is a just reward for not spending. Under no consideration should society and the Government allow itself to be dependent upon the savings and the created bank credit of a few financiers, for depending upon them means that we must amply reward them. What would one naturally think of a group of farmers heavily in debt, but highly capable, who make a practice of hiring some ambitious farmers to do all their work? Society heavily in debt, but highly capable, hires capital to manufacture all bank credit. There is just as much logic in the former as in the latter.

Today we have what is known as capitalistic banking, noncooperative and nonrepresentative, under Government insurance for capitalistic profit only. I see no special reason why society cannot enjoy what is known as people's cooperative and representative banking under Government endorsement free of all interest to capital.

Before an individual can grant a loan he must have within his possession cash to the full extent of the loan. An individual has no power of manufacturing a form of credit that can be used in making a loan. It is true that an individual can manufacture credit, but only banks can manufacture negotiable credit. The type of credit that the individual manufactures is the open charge account, and this type of credit, of course, is not transferable. Under our present banking system only a small amount of cash is used in making a loan. The balance that is used in making the loan is the credit that these commercial banks are capable of manufacturing. The law, however, requires that these commercial banks keep a considerable amount of cash on hand for the purpose of redeeming a certain percent of this credit that they are allowed to manufacture. Under people's banking there would not necessarily have to be any cash on hand in making a loan as the entire loan could be made from the credit that these cooperative banks are capable of manufacturing. Nor would there necessarily have to be any cash on reserve for the purpose of redeeming this Government endorsed bank credit that these cooperative banks are capable of manufacturing.

There are two definite reasons why the commercial banks cannot operate entirely on their manufactured credit. The first reason is that there is not complete unity among the various banks. Each bank is a separate institution working independently of other banks. None of these banks are compelled to honor each other's paper. During a depression the larger banks in many cases refuse the credit of smaller and weaker banks. The second reason is that there is a vast difference between the acceptability of cash and bank credit. Cash is a promise of the Government to pay, while bank credit is a promise of a particular bank to pay. The people, especially during a depression, prefer the promise of the Government to pay over the promise of a particular bank to pay. However, under people's banking, we find that there will be complete unity among the various banks. Each bank will serve as a separate link in the same endless chain. Each member bank will be compelled to honor the paper of other member banks. There also will be no difference between the acceptability of cash and Government endorsed bank credit. Both cash and Government endorsed bank credit will be a promise of the Government to pay. The only difference we can find between these two types of medium of exchange is that the credit is much easier controlled. It is to be remembered that cash is only acceptable as long as it is controllable. Shortly after World War No. 1 the German Government failed to keep their cash under control. Failure of the German Government in this respect led to the repudiation of the mark throughout the world. So we find that Government endorsed bank credit will not only

be as acceptable as cash, but much easier controlled, more convenient, and more elastic.

A careful summary shows that an individual in making a loan must use cash entirely. The commercial banks must use part cash in connection with the credit that they are allowed to manufacture while the cooperative banks could use credit entirely.

Since the commercial banks find it necessary to operate on considerable cash for the purpose of making the loan and redeeming the credit, the use of cash for this purpose is in demand. Since the use of cash is in demand for this purpose, interest must be paid for its use. Interest on time deposits under our present banking system is absolutely essential. If it were not essential I do not believe that banks would hesitate in the least in refusing to pay interest on deposits.

However, under people's banking, we find that cash would not be used either in making a loan or in redeeming a credit. Since cash would not be used for this purpose, the use of cash for this purpose would not be in demand. Since cash would not be in demand for this purpose, interest on deposits would be unnecessary. For these cooperative banks to pay interest on time deposits, where the loan completely creates the deposit, it would be sheer folly.

Now, we find that interest on both cash and bank deposits is not only fundamentally unsound, but under a revised banking system, absolutely unnecessary. Interest on bank loans is a different proposition entirely.

To eliminate interest on bank loans or even to reduce it to a mere handling charge would be too revolutionary. This highly revolutionary act would cause the Government to make more adjustments than would be advisable. A normal rate of interest must be paid on all bank loans. The question therefore arises as to who should receive the interest. It would not be necessary or advisable to pay any of this interest to bank depositors. No part of this interest would be paid to the stockholders for the simple reason that there would be no stockholders under this type of banking. These cooperative banks would have no special use for this interest, so the logical thing to do is to turn all this interest over to the Government in the form of a revenue for the desired purpose of balancing the Budget.

All Government bonds and other indebtedness could be liquidated in favor of non-interest-bearing Government endorsed bank credit. The saving of interest on the national debt plus the net income from banking would benefit the Government to the extent of approximately $7,000,000,000 a year. One can see that the Government could also finance the war through these cooperative banks without selling bonds or stamps to the public.

By liquidating all bonds, defense stamps, mortgages, preferred stocks, and bank credit in favor of Government-endorsed bank credit, there could be a serious effect upon a nation at war, unless proper legislation is immediately installed. Due to the fact that all this credit will be placed at the people's immediate disposal, the people would readily be enticed to spend freely. Needless spending is one of the things that the Government desires to hold in check during the war.

There are three good reasons for this: First, to conserve on vital material that could be used for the war effort; second, to halt inflation; and third, to build up a nest egg for the individual following the war.

Since the attack on Pearl Harbor, the Government has done a remarkable job informing the people of the necessity of buying bonds and stamps. Would it not be a good policy for the Government to go all out informing the people of the necessity of saving or of the danger of spending? There will be a large class of people who, upon finding they can no longer increase through interest, will spend less for the purpose of preserving their principal. We have a class of people who are spending their incomes as fast as they are earning them simply because they sense a collapse of our financial system following this war. When these people learn that the Treasury can be amply reimbursed, they will no longer harbor this fear. In case the majority of the people do not heed the sound advice of saving, the Government could resort to either rationing or freezing a percent of the credit and incomes. Selling bonds and defense stamps to the public is a means that the Government is using today in freezing credits and incomes. Under the people's banking, the Government would no longer have to bribe the people with interest on bonds and stamps in order to freeze credits and incomes.

Some people have been recently preaching the false doctrine that no matter how large our debt is, or how much interest is paid on that debt, society would not necessarily have to suffer any evil effects. These people point out that we do not owe this debt to any foreign nation but only to ourselves. To these people I wish to ask the question: "Would it be less difficult to pay organized capital hard-earned dollars, or pay some foreign nation with our surplus goods?"

These people have overlooked another important fact, and that is—a nation cannot exist half slave and half free. The bulk of this great debt will have to be paid by children yet unborn to the heirs of the rich. The greatest contribution that we can make to posterity is to pay off this debt as quickly and legitimately as possible. If we feel that we are justified in enslaving our own people, part of which are yet unborn, by interest on the national debt, what is to keep us from feeling justified in enslaving the people of foreign lands? United States, the richest and the most humane nation in the world, can no longer tolerate either enslavement here at home or abroad.

Even after reading this treatise, some people may be at a loss to understand where these cooperative banks will get the purchasing power to finance both the Government and the people. Perhaps the best way to answer this is to ask this question: "Where did all the money and credit come from in the first place?" Both money and credit were originally manufactured—cash by the Government and credit by the bankers. These cooperative banks could almost overnight manufacture enough credit to replace all credit now in existence. They could, if necessary, manufacture enough credit to replace all cash. So we find that it is not a problem for these cooperative banks to have purchasing power; it is purely a problem of being able to manufacture a purchasing power capable of replacing a purchasing power in existence.

Some people may have the opinion that people's banking is merely Government banking. This is far from being the case. The reason why this writer so strongly advocates people's banking is because he fears that our present banking system is slowly but surely giving way to either Government banking or communism.

Under Government banking there would be red tape, graft, corruption, politics, unfair partiality shown, and even interest to capital would predominate. Government banking would be operated directly from Washington, D. C., while people's banking would be operated by a board of directors elected by the people from each county. People's banking would be far more democratic than our present banking system as all the people would be given an equal voice. People's banking would function similar to our public schools, with the exception that all bank employees would be under civil service.

Ultraconservatives off-hand will stamp this type of banking as being communistic. Under communism the producers and nonproducers practically share alike, while under people's banking a premium is paid only to those who produce, or those who possess productive assets. Under our present form of banking, the producers are penalized so heavily through interest and taxes that their premium is reduced to a mere pittance, while we find that the nonproducers, such as the financiers, are highly rewarded. No, people's banking is not communistic. It is purely capitalistic with teeth in it. People's banking is designed to perfect the capitalistic system for the purpose of promoting essential social reforms.

This writer bears no malice toward capital. In fact, he rather admires capital. Furthermore, we have no right to condemn capital. We can only condemn the financial system we have fallen heir to. Capital is only commercializing off of a financial system that they themselves never installed. Capital, in financing the Nation, is merely performing a duty that society has needlessly neglected to do. If interest taking is considered a crime against society, I feel that capital is wholly unaware of it. Within the past year many small business concerns gave up their earned incomes willingly when the Government so demanded it. I have every reason to believe that the financiers will just as willingly give up their unearned incomes when the Government so desires. There is no question that capital, unless curbed, will destroy itself, but only after the great masses have suffered unnecessary hardships. The time is not far off when capital must decide whether to give up this unearned income or wait and assume the risk of losing the entire principal. This Nation, nor any

other nation, can expect its people to pay approximately $4,000,000,000 of interest annually on a national debt.

Some people with a small accumulated savings may feel that they should have this interest to live on during their old age. If any interest is paid to these people under this type of banking, we would have to look upon this interest as charity. As a rule, we give charity not to those with principal, but to those without. There is not a law that prohibits these people from engaging in a productive enterprise and thus receive an earned income. If these people do not desire to engage in productive enterprise they can, upon depleting their savings apply for an old-age pension. The Government, by receiving this interest, will be in a position to grant old-age pensions to those who are deserving. Both interest and old-age pensions are forms of charity—the only difference being that old-age pensions are paid to those in distress, while interest, of course, is paid to those who are not. Therefore it would be more logical to give old-age pensions to the needy than interest to those who have no want.

Naturally, insurance companies will have to make various adjustments under this type of banking. There is no reason why an insurance company should not be allowed to engage in productive enterprise the same as any other company. If an insurance company feels that it cannot operate without interest it will have to liquidate its holdings. No insurance company can expect society to practice a system that is fundamentally unsound just in order for them to operate. Since these insurance companies can no longer receive interest the person who is fortunate enough to own an insurance policy may find his premium somewhat higher. I do not believe that the average policyholder would object in having the Government receive this unearned income in order to balance the Budget. I actually believe that they feel that they are no more entitled to this unearned income than they are to the taxes that the Government is now levying on the public.

This writer's sympathies have always been with the under dog. I do not believe that the under dog would object to pay all this indirect interest on consumable goods as long as the Government received the entire revenue. To ask the under dog to pay all this indirect interest on consumable goods for the sole purpose of benefiting a large group of financiers appears to be neither fitting nor proper.

The main reason for people's banking is not merely to force capital to engage in productive enterprise and thus create more consumable goods and employment, nor is it to take away all this unearned income from capital and give it to the Government for the purpose of balancing the Budget and promoting social forms, but to set up in this country strong, sound credit institutions that will forever serve as a check to future inflations and depressions.

The loan value more or less determines the selling value. When the loan value is increased the selling value is also increased, and when the loan value is decreased the selling value is likewise decreased. Moneys and credits, besides serving as a medium of exchange, also serve as a measuring stick. All values are measured in moneys and credits. By increasing the amounts of moneys and credits in circulation values rise, and by decreasing the amounts of moneys and credits in circulation values drop. All credits increase or decrease in direct ratio to the amount of loans in existence. In other words, the more the loans the more the credit, and vice versa.

During World War No. 1 prices advanced on raw materials due to an increased demand. The bankers being of the impression that values would remain high, felt that they were secure in commercializing on the credit that they were allowed to manufacture. Bankers actually fell over themselves in making exorbitant loans to the public. These loans caused prices to skyrocket to such an extent that it inflicted great hardships on a great number of people. Now it is easy to understand how the noncooperative banks can, by making exorbitant loans, turn a mild boom into a wild credit inflation.

During the late 1920's values gradually declined because of a lack of consumption, due, of course, to various causes. The bankers being of the impression that values would even seek to lower levels, became panicky. The bankers not only refused to make new loans to carry on normal business but actually called in many perfectly good loans. This curtailment and liquidation of loans caused prices to slump to all-time lows. The financial condition of the Nation became

so acute that the Government found it necessary to declare moratorium, which led to the insuring of bank deposits. Here we find how easy it is for our banks to turn a slight recession into a severe depression by the curtailment and liquidation of loans.

Under people's banking, we find that only the Government will share in the profits and losses. Since only the Government will share in these profits and losses, there will be no excuse for greed shown during a boom or panic shown during a recession. During a boom, these cooperative banks will, of course, refuse to make exorbitant loans; and during a recession, these cooperative banks would under no consideration curtail and liquidate loans. I have every reason to believe that under a strong cooperative banking system we can attain stabilization of both prices and wages.

Perhaps over a long period of years the interest on loans could be gradually reduced to a mere handling charge. Whether this would be advisable or not I am in no position to say. By reducing interest to a mere handling charge it would be highly capitalistic; while allowing interest to remain on loans for the purpose of promoting social reforms would, of course, be socialistic. Perhaps by mixing a little socialism into our capitalistic system, our capitalistic system will be made immune to total socialism.

My purpose in writing this treatise is not just to sell the people on the type of banking that I advocate, but to impress them with the necessity of investigating our present financial system. I feel that after the people have once made a thorough investigation of our obsolete banking system, they will demand a change.

Whoever it was that originated banking may not have been a genius, but perhaps he did as much for civilization as any man who ever lived. I do not believe that it was this good man's intention for any prominent and ambitious people to receive a royalty. If it were his intention, how much longer will it be before this royalty expires?

I realize that people's banking is somewhat revolutionary, but if our Government is to balance the Budget, help war-torn Europe, and at the same time promote essential social reforms here at home, we must enact some legislation of a revolutionary nature.

A careful analysis of this plan will show that the Government will receive a tremendous revenue; yet we find that the burden will be so light upon the people that Congress might see fit to temporarily freeze a certain amount of credits to regulate spending during this emergency.

Within the past decade it appears that world events have been changing faster than the human mind. Our duty is to concentrate, sacrifice, and perhaps even to die if necessary to win this war. However, we must not overlook the fact that our Government is dangerously in debt. If we are to keep our Government solvent during the period of reconstruction following the war, we must act while our democracy is still intact—so help us God.

(Signed) MAURICE JAMES SAFLEY,
Author.

(Signed) HERBERT W. OVESEN,
Consultant.

The CHAIRMAN. Mr. Martin Popper.

(No response.)

The CHAIRMAN. Are there any other witnesses here who have come down to appear before the committee?

We have 25 minutes that we could very well use. If there are any witnesses in the room whose names do not appear on the list this morning, if you have a statement to make to the committee or wish to appear on any question, we would be glad to hear from you now.

Mr. O'NEAL. I would be glad to appear before you, sir.

The CHAIRMAN. Yes, sir. Come right up. Are you listed on any other date?

Mr. O'NEAL. No, sir. I just went into the committee room but the secretary was out. I have no papers but my statement.

The CHAIRMAN. Give us your name.

Mr. O'NEAL. John R. O'Neal, 4420 Fourteenth Street NW. I am a retired farmer.

STATEMENT OF JOHN R. O'NEAL, WASHINGTON, D. C.

Mr. O'NEAL. Mr. Chairman and gentlemen of the committee, I am here to represent the poor people of this country. There are plenty of them here to represent the rich.

I was born on a rented farm in 1870. My father died when I was 12 years old. I worked on the farm for 25 cents a day for 2 years. When I was 14 years old I went into industry, and I worked in industry for 10 years, and I know what a man is up against in industry if he hasn't such men as Bill Green and John Lewis and Mr. Murray to back him. I didn't have them. I knew what I was up against.

After 10 years I rented a farm for a few years and then bought a farm, and I know what a farmer is up against when he has nothing to say about selling his crops, and I want to talk about that today.

This Mr. Goldman I heard talking said more here than I have heard said in months. What is to be done? I mean for compulsory savings. I couldn't hear him so well, so I don't know when he left off to make a man pay compulsory savings. If he wants to make a man pay compulsory savings when he is getting $40 or $50 a month or less, I can't agree to that; but if a man is getting enough to pay, I believe in making him pay compulsory savings.

A few years back in New York they investigated men up to 65 years, at the end of 65 years—what they were living on and what condition—and they found there was such a big percent of them had no income at all. They were living on charity or their children, and it is necessary, gentlemen, to have compulsory savings.

You made the best illustration of that yourself a few years ago. The greatest bill you ever passed in Congress—you passed the Social Security Act. That made compulsory savings. The one mistake that you made, gentlemen, when you gave the manufacturer or the employer all the credit of putting up that money for people to retire on. You gave them the credit for it, when the man that is earning it got credit only for a small part of it; and the greatest mistake you ever made, gentlemen, was when you didn't do your duty and follow it up to give social security to the farm employees, and that is what I want to talk about today.

You have never followed it up and given the farm hands social security, because the farm leaders have never asked it of you. Ed O'Neal and Tabor and Evers have never asked it. We have now a new man in the Farmers Union. I don't know what he has done, but if he has asked it, I never knew of it, and you Congressmen, as Congressmen, have fallen down flat on doing your duty to the farm hands. The reason you have not done it, gentlemen, is because the farmer didn't have Bill Green or John Lewis or Phil Murray to organize him and be back of him and make you gentlemen afraid of the farm-hand vote.

The President and Secretary Wickard have both advocated social security for farmers and their employees.

I am against a sales tax and, gentlemen, you will find the men that have come before this committee and men in Congress who are for this sales tax are the very men, gentlemen, when you had 10,000,000 to 15,000,000 men unemployed, were here fighting against the farmer or anybody else, getting anything. They talked against it. They get up

here and talk about when we had a debt of $40,000,000,000 in the United States; talk about balancing the Budget, economy, economy, balance the Budget. We are on the edge of bankruptcy, but now you have men to vote a hundred billion or two hundred billion or three hundred billion to lick Hitler and Mussolini and Japan, and I give them credit for it. I believe in licking them.

I was before the committee in 1940 and told you then, when the first war tax bill was passed, that I believe in taxing this country to lick Hitler. He has declared war on America and all democracy, and I accepted his challenge and I believe in going after him. It was in September 1940 I said, gentlemen, if I had my way I would go over and whip him on his own ground. That was before Pearl Harbor, gentlemen. I would go over and lick him on his own ground.

The CHAIRMAN. We will have to ask you to confine yourself to the question. If you have said all you want to say on that——

Mr. O'NEAL. Just a few days ago you saw in the paper that a bunch of milk dealers here and their employees agreed to a week's wage raise. They were getting $41 and they raised it $2.50 a week. I have no objection to it, and I am not complaining about the boys getting too much. They get $30 a week commission. That runs them to about $220 a month. Now, there are 1,350 men handling these 12 creameries.

Out on the farms between seven and eight thousand men are producing that milk, and the men on the farm, the hands, are drawing about 25 cents on a dollar of what these milk deliveries get the boys, and a man here in town making $220 a month can buy a $10,000 house and take 1 week's wages and pay for it in 20 years.

The man on the farm lives in a furnished house, but a man in town can pay for his home in 20 years and still have three times as much left as the farm hand, and if you pass a sales tax, Mr. Chairman, and put a sales tax on the farm hand, where is he with the wages he gets? Where is he? He is sunk. The farmer is sunk if you pass a sales tax, and I am against a sales tax of any form—retail or wholesale sales tax. It is not democratic, gentlemen, to tax a man that is getting little.

The CHAIRMAN. All right, Mr. O'Neal. Thank you, sir.

We have no witnesses scheduled for the afternoon, and so the committee will be in recess until tomorrow morning at 10 o'clock. We have full days beginning tomorrow and on all the other days of the week while the hearing is going on.

(Whereupon an adjournment was taken until Wednesday, July 9, 1942, at 10 a. m.)

REVENUE ACT OF 1942

WEDNESDAY, JULY 29, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will come to order, please. Mr. Davidson.

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

Mr. DAVIDSON. Mr. Chairman, my name is Clinton Davidson. I represent the Fiduciary Counsel of Jersey City, N. J., a financial research organization. Our company represents approximately 40 medium-size corporations, the Johnson Wax Co. being typical, but this morning, I have a personal, even selfish reason in appearing before you. I believe that neither capitalism, nor the American system of free enterprise can survive another long period of mass unemployment such as we had from 1930 to 1934. I was brought up in real poverty, probably greater than that experienced by any member of this committee, and the American system gave me an opportunity which I would not have had in any other country. I want to preserve it for my grandchildren. I wish to discuss a tax program which will avoid unemployment after the war and yield the largest possible revenue during the war.

Now, Mr. Chairman, I expect to use quite a number of figures, I have some charts here and if you please, I should like permission to use these charts.

The CHAIRMAN. Yes, sir; you may use them.

Mr. DAVIDSON. Thank you, sir.

As I said, we have a tax program which will stimulate postwar reemployment and recovery, and which will also, we believe, give the largest possible revenue during the war.

I would like first to present the problem of agriculture after the war as our organization sees it. I think most of you remember that during the last war the farm prices were raised and the farmers bought more land, mortgaging their property to do so, and then after the war farm prices were lower and the farmers were not able to pay the interest on their loans, and not able to meet the mortgages. We believe the same thing will happen again unless we plan otherwise, and one method, as I shall show, of planning otherwise, is for labor in this

country to be employed and to be paid sufficient wages so that they can buy the farm products, and for industry to operate at full force so it will be able to use the industrial farm products.

As an example, in 1937 the farmers produced 13,000,000,000 gallons of milk, and this year they are producing 15,000,000,000 gallons of milk. When the war is over and we return to peacetime, unless there are some definite plans made, the farmers will have a surplus of 2,000,000,000 gallons of milk which, with reduced prices, will be very hard on them.

One method of preparing to eliminate that difficulty is that if the laborers of this country are all employed at sufficient ways, they will be able to use quite a bit of that 2,000,000,000 gallons of milk. In addition to that, as you know, we use milk, skimmed milk, that is casein, in a great many industrial products, and if industry is operating at full force we will use a good deal of milk in casein products.

Senator VANDENBERG. We can use all the milk if Vice President Wallace achieves his ambition of giving everybody all over the earth a quart.

Senator DAVIS. We would have sufficient to go around to all of them.

Mr. DAVIDSON. The next illustration—I am using only a few of many that could be used—is soybeans. In 1937 the farmers produced $38,000,000 worth of soybeans, and this year $350,000,000, almost 10 times as much.

The farmers cannot keep up that production of soybeans, they will not be able to sell soybeans to that extent, unless industry is operating at full force.

I shall not go into detail on the next chart very much, but I think that a great many people are interested in the cotton problem after the war.

We have estimated that our pre-war normal export was about 6,000,000 bales. At the present time it is less than 2,000,000 bales.

The former importing countries are now producing satisfactory substitutes, and after the war the export will probably be the same as the present, that is, 2,000,000 bales.

Our probable production will be 14,000,000 bales, domestic consumption 6,000,000 bales, export, 2,000,000 bales, making 8,000,000 bales, and unless some plan be made there will probably be an annual carry-over of 6,000,000 bales of cotton after the war.

So we have to plan something for that.

Now, a great many people think the answer will be the export markets. Before we prepared these charts we discussed this subject with economists in practically every department of the Government, and I think, with only one exception, they agreed that unless we plan now, we would have tremendous difficulties after the war and there would be mass unemployment. One man, and only one said that we would have boom years for at least 10 years after the war, and maybe 20 years.

I said, "How could that be brought about?" He said that there would be a pent-up demand for our products from all over the world and that the supplying of this demand would result in a tremendous boom.

Well, we agreed with that, but we said, "How can those products be purchased? Where will the rest of the world get the money to buy the products?"

The reply was, "We will lend them the money on the lease-lend basis," and that is the only way they can be purchased.

Now, very few people realize that our products are sold largely in countries having a high standard of living. The things that we manufacture are not sold in darkest Africa and they are not sold in the jungles of South America; I really should have looked this up, but I believe that the little country of Belgium prior to the war, bought as much of our products as nearly all of South America. I do know, and I believe you know that the large, friendly country of China bought from us before the war only a fraction of what was purchased by the smaller, unfriendly Japanese. Forty percent of our export went to Europe and 15 to Canada, more than half of our export going to those two places.

We believe that Europe will not be in a position to buy anything like that much after the war, for these reasons: Prior to the war, Europe had billions invested in this country, in American investments, and the income from that, amounting to several hundred millions a year, was used by Europe to purchase our products, but we know that those investments have been sold and are being sold, and when the war is over they will not have the investment income to purchase our products.

We also know that most of the shipping was done in European ships, but they are being sunk very rapidly, and we are building ships so fast—we are building a much greater merchant marine than Britain ever had—that after the war Europe will not have that shipping income.

In addition, we purchased from the European colonies rubber and various other products to the extent of about $900,000,000, and at least that much money went from these colonies back to Europe and Europe had approximately $900,000,000 a year to use in buying our products, which they will not have after the war.

So, I shall say, instead of that being the answer to the problem, it is really one of our greatest problems. Our export markets will then be ex-markets.

I have discussed very briefly and most incompletely the effect on agriculture. Next I want to show the effect upon labor.

In the shipyards in 1937, our largest peacetime year, we had 62,000 workers. This year we will have 1,250,000 workers, and it was estimated, I believe, that next year there will be 1,500,000 workers.

When the war is over there is one thing that we will not need to do, and that is to build ships, and there will be practically no workers in the shipyards; so we will have more than a million men trained for the building of ships whom we will not be able to employ.

In 1937, our largest peacetime year, I believe, in the automobile industry we employed 562,000 workers. Next year, in that industry, we will have 1,500,000 workers—not building automobiles, of course, but building tanks and various weapons of war.

After the war is over it has been estimated that we will not be able to employ more than we had in our largest peacetime year, which

means that we will have at least a million idle men trained for the production of war machinery in the automobile industry for whom there will be no work.

I shall not take the time to discuss the various metals, but these columns will give you an illustration of the distribution for war purposes of our various metals.

Senator BROWN. Mr. Davidson, I agree with you up to the automobile business there, but don't you think the fact there will be a great shortage of new automobiles, at least for some time, will require a pretty heavy production in the automobile business?

Mr. DAVIDSON. We got the figures from, I believe the name is, the Automobile Chamber of Commerce, and we found, when we got figures from such organizations, if there was any fault they were too optimistic. They do not believe that there will be, counting the change-over in machinery, and all that sort of thing, they do not believe there will be a greater employment of labor there, the first year or two after the war than there was before.

Senator BROWN. There are, roughly, from 28 to 30 million automobiles in use in the United States in average times. If for a period of 3 or 4 years you stop producing 4 to 5 million automobiles per year, it does seem to me that there will be a pretty heavy latent demand for automobiles.

Mr. DAVIDSON. No doubt you are right, sir; but the industry seemed to think the actual number of employees would not be higher than in the previous peacetime years.

Senator BARKLEY. If anyone has money enough left to buy one.

Mr. DAVIDSON. Perhaps so.

Senator BROWN. You, perhaps, did not see the swell model he had.

Mr. DAVIDSON. In regard to the metals, we were talking last week to an executive of one of the largest drop-forge plants in the country, drop-forging steel for various airplane parts, and he stated that when the war is over their whole plant will have to be changed over, because there is going to be a demand not for the steel, but for the light metals.

We have had various people tell us that the increased use of magnesium and aluminum, in the lighter metals, will find new employment, but what it will do is merely take laborers who were formerly working in the heavy metals, and have them working in the light metals.

Here is the most unusual chart, I think. The largest peacetime year for the aviation industry resulted in 24,000 employees. By next year there will be 1,700,000 employees in the aviation industry, a greater number than we had in peacetime in steel, in automobiles, in textiles, or in any industry in existence.

Within just 2 or 3 years, the aviation industry jumps from one of the smallest, even lower than the shipyards, to larger than any industry we had in peacetime.

It has been estimated that when the war is over, if all first-class mail is carried by plane, if all Pullman passengers ride on planes, and if all ocean-going cabin passengers use planes, we will then be able to have 200,000 workers in the aviation industry, which will leave 1,500,000 looking for work.

Without taking your time to go into detail regarding all of the various industries, we secured, from the Office of Facts and Figures,

this figure, that when the war is over, there will be coming out of the war industries 20,000,000 workers, and according to General Hershey, 10,000,000 coming from the armed forces of this country, leaving 30,000,000 looking for work.

Some of those will be women, and they will go back home—we hope—and some of them will go back to the farms, and some of them will find employment readily, but we estimated that there would be at least 18,00,000 who will have great difficulty in finding work.

So we say that unemployment plus demobilization may equal demoralization.

As I said at the beginning, we discussed the subject with economists in the Government and with economists outside. I think we discussed it with some fifty-odd economists and alleged economists, and in every case we were told that capitalism, or the American system of free enterprise, cannot possibly survive another long period of mass unemployment such as we had in 1930 to 1934.

We mean by that that unless we plan to avoid unemployment and if we have those 18,000,000 people looking for work, there are going to be mobs, and we mean that the system to which we are accustomed will simply not survive.

So we say that it is extremely important, while we are fighting the war, to plan to put this sign in the various industrial plants when the war is over. The sign reads "Men at work."

Senator VANDENBERG. Your chart shows that sign up in Canada. I wish you would bring it down into the United States.

Mr. DAVIDSON. We will have to change that one.

Senator BROWN. I notice it ends up in a Republic State.

Mr. DAVIDSON. Occasionally we have been criticized for spending time and effort on the subject of post-war planning, but we believe that business should spend time and effort in post-war planning in order to work hand in hand with Government, which is spending a tremendous amount of time in post-war planning.

Almost every department of the Government has a post-war planning division. I think—at this time I do not know the exact number—there were as many as 300 men engaged in post-war planning in the Department of Agriculture.

The Department of Labor has a post-war planning department. I think they were granted an appropriation of $90,000 not long ago just to make one survey for their post-war planning purposes.

So, even in the Department of State, in every department of the Government practically, there is a post-war planning department. Of course, those plans are based upon what the Government will do after the war, and they are based upon money to be spent by the Government.

The President established the National Resources Planning Board, and the main job of that Board has been post-war planning, and this is the plan which they published, that when the war is over we will have to have several billion dollars spent each year for armed forces to police the world. I believe Mr. Sumner Welles made a speech not long ago and alluded to that subject. That it will be necessary to use several billion dollars for foreign loans to revive the markets for American goods.

My personal idea is that those loans will be paid just like the lend-lease loans, in whatever manner that might be.

Then, in addition to that, there has to be several billion dollars used in public works, such as W. P. A., C. C. C., and N. Y. A.

The plan stated that the total of these items would amount to $15,000,000,000 a year, and that that amount should be spent by the Government.

We think that if business will do its part it will not be necessary for the Government to spend so much.

We then say that Congress might hesitate to add $15,000,000,000 a year to this leaning tower of debt when the war ends. I do not know what the total debt will be because I do not know when the war will end.

The Tax Foundation estimated that the indebtedness would be $266,000,000,000. I believe over $200,000,000,000 has been appropriated for war, but, to be conservative, just suppose that this debt totals $200,000,000,000 when the war is over, the interest on that at 2½ percent will be $5,000,000,000 and will equal the total 1939 tax bill, which means that to pay that interest we would have to have one tax bill as large as the one in 1939 for that purpose alone, and then we will have to have another bill to pay your salaries and pay for the other expenses of running the Government, and we question whether Congress would pass a bill of $15,000,000,000 a year to help avoid unemployment after the war.

Now, here is the problem: We have to change from war economy over here [indicating] to normal peacetime economy, and the bridge that crosses is national income and national employment. The column that supports that bridge is investments.

We produce two kinds of goods—consumer goods and investment goods. When these goods are produced incomes are paid out to those who produce them. that part of incomes spent for consumption takes consumer goods off the market and enables their production to be continued. That part of incomes which people save must be spent for investment goods if full production is to be maintained. The more we save the more has to be spent on investment goods, to absorb these savings and keep men at work producing things that will be bought. If we save 10 percent of our incomes, then 10 percent of our total production must be in the form of investment goods. If we save 20 percent, then investment goods must account for one-fifth of total production. If we save 33 percent, investment goods must account for one-third of production. Once people get in the habit of saving a certain percentage of their income, they do not change their rate of savings substantially or quickly, but the amount invested in factories, machinery, public utilities, housing, and public works does change substantially and quickly regardless of what percentage of income people save. For this reason the amount of investment usually determines the size of the national income and the amount of employment.

In 1937 individuals saved 10 percent of their income. This meant that investment goods had to account for one-tenth of total production. Opportunities could be found to make investment outlays of only $7,000,000,000. As a result, the national income was only $70,000,000,000, and there was considerable unemployment, because $7,000,000,000 is one-tenth of $70,000,000,000. If $10,000,000,000 of investment opportunities could have been found the national income would have risen to $100,000,000,000, and there would have been very little

unemployment. If, after the war, people again save only 10 percent of their income, $10,000,000,000 of investment opportunities will enable us to produce near capacity with almost full employment. Under such conditions, the investment column would have to be only $10,000,000,000 high to support the bridge of prosperity above the chasm of depression.

In wartime the demand for investment goods is abnormally large, as we have demonstrated with the charts showing the abnormal expansion of metal production which provides the raw materials for investment goods. We are therefore forced by the war to save enough of our income to pay for this abnormally large production of investment goods. In 1943 we will have to save at least 30 percent of our income because of the war. If the habit of saving 30 percent should continue after the war, we would need $30,000,000,000 of investment opportunities to enable us to produce a national income of $100,000,000,000, because $30,000,000,000 is 30 percent of $100,000,000,000. We do not think the savings habit will continue as high as 30 percent, nor do we think it will fall to the pre-war rate of 10 percent. It is likely to be somewhere in between these two extremes, possibly 20 percent, in which case the investment column will have to be $20,000,000,000 high. It is interesting to note that the investment column was about $20,000,000,000 high in 1941, that the national income was $95,000,000,000 in that year, and that unemployment was relatively small but still larger than the irreducible minimum. Furthermore, $10,000,000,000 of investment in 1940 provided a national income of only $77,000,000,000, and unemployment in that year was about 7,000,000.

Some people think that we may save less after the war, because consumers will spend more of their income to buy automobiles and refrigerators which they could not buy during the war. In 1941 consumers did buy more of these durable goods than they normally would, because they knew they would not be able to buy them later. In spite of spending $10,000,000,000 for this purpose, one-tenth more than was spent in 1929, there still remained savings of $20,000,000,000 to be absorbed by investment outlays. For these reasons, we think the investment column after the war will have to be about $20,000,000,000 high to maintain full production and employment. If the post-war savings rate is 2 percent and we find investment opportunities of only $10,000,000,000, about the same as in 1940 and in 1929, our national income will be only $50,000,000,000, for $10,000,000,000 is one-fifth of $50,000,000,000. When adjustment is made for changes in the price level, this would be the same level of production and employment as in 1932.

The stones in the investment column represent the various uses to which investment goods can be put. In constructing the post-war investment column we have made the most optimistic estimates possible of the size of the various stones. It is our opinion that, unless special plans are made to stimulate various types of investment, these stones will be much smaller than they are shown in the chart.

The bottom stone represents net-capital expenditures, after depreciation, for all public utilities, including electric, telephone, and railroads. The figure $1,800,000,000 is the amount of net investment in 1929. In that year there was considerable gambling in the securities of railroads and especially electric-power and light companies. As a

consequence, these companies raised much more capital and spent much more for expansion than was normal. For some years thereafter this excessive expansion was balanced by a very low level of investment. A repetition of speculative investment in public utilities is not likely after the war, and it is probably more reasonable to assume that this stone will be only one-third as large, comparable to the $500,000,000 of investment in 1937.

The second stone represents commercial and miscellaneous construction, such as office buildings, stores, etc. The figure "$1,500,000,000" represents the amount of net investment in 1929 when we had a skyscraper-building spree. In view of the fact that many of the bonds sold to the public to provide the funds for constructing these office buildings in 1929 are now selling in the market at only 50 cents on the dollar, we are not likely to have another office-building spree after the war. This stone is more likely to approximate in size the $700,000,000 so invested in 1937.

The third stone represents net investment in new houses. By net investment we mean the amount spent for residential construction after subtracting the amount of depreciation on houses standing each year. This depreciation was $2,500,000,000 in 1929, and in recent years it has run about $1,800,000,000. The figure $4,000,000,000 shown in the chart is the most optimistic estimate that can be made and is almost four times as large as the $1,000,000,000 invested in 1929 and the $900,000,000 of net investment in 1941. The stone can be this large only if special steps are taken to reduce building costs or to subsidize house building. The development of prefabricated housing is the most hopeful step that could be taken along these lines.

Another stone that might be in the investment column would represent the capital expenditures of farmers for buildings and farm machinery. The reason why it is not shown in the chart is that annual depreciation of farm plant and equipment is about as large as gross investment in most years. It is true that such expenditures exceeded depreciation by $100,000,000 in 1929 and in 1937. That might happen again after the war if we take steps to achieve full employment at home, to feed Europe, and to maintain farm prices.

The three lowest stones shown in the chart add up to $7,300,000,000 if we make the most optimistic assumptions possible. This is not enough to build a column $10,000,000,000 high, which is the minimum that under any stretch of the imagination could sustain business activity at a prosperous level. To build a column that high at least $2,700,000,000 of other investment stones must be found. To build a column $20,000,000,000 high, which we think will be necessary, additional investment stones aggregating $12,700,000,000 must be found. Possible stones that we can use to construct this column high enough to support the prosperity bridge are (1) investment in manufacturing and mining plant and equipment; (2) Government deficit spending for public works and relief; (3) lending abroad to pay for a favorable balance of trade; and (4) additions to business inventories.

The fourth stone, investment in manufacturing and mining plant and equipment, is the one that everyone wants to be the largest stone in the column, because it represents expansion in our capacity to produce manufactured goods. The larger this stone is the smaller will the other stones have to be. Everyone wants the stones representing Government spending, lending abroad, and additions to inventories to

be as small as possible. The only people who advocate putting Government spending and lending abroad into the investment column are those who fear the column will not be high enough to sustain prosperous business activity if these stones are left out. I am sure they would want to discontinue Government spending if investment in manufacturing plant and equipment could become a large enough stone to take its place. How large could this stone possibly be if we do not take any special steps to make it grow? In 1929, when a stock market boom brought about more manufacturing expansion than most economists considered to be necessary at the time, net manufacturing investment was only $1,500,000,000. In 1937 we had another temporary boom in manufacturing expansion with a net investment of $1,000,000,000.

Let us assume that after the war businessmen will have as much confidence as they had in 1929 and that investment in manufacturing will again amount to $1,500,000,000. A stone of this size added to the three lowest stones, amounting to $7,300,000,000, would make a total column $8,800,000,000 high. This would not be high enough to support a bridge over the most shallow chasm that we can possibly conceive of. Such an investment column would be less than half as high as the $20,000,000,000 which we think will be necessary to support the post-war prosperity bridge. Yet we have made the most optimistic estimates possible in building up these four stones. More realistic estimates of the probable post-war size of these four stones would build a column only half as high as the one shown in the chart. It is difficult to see how we can maintain a high level of business activity and employment after the war unless Government deficit spending is tremendously large, perhaps $10,000,000,000 to $15,000,000,000, or unless we make specific plans now to stimulate the growth of the other stones in the post-war investment column.

Two of the stones have been placed at the side of the investment column in the chart and are called faulty stones. The reason is that they represent types of investment expenditures which cannot be continued year after year and which sometimes represent negative figures which reduce the size of the investment column. Everybody remembers that in the 1920's we were able to export more than we imported because we lent money abroad in order to provide foreigners with the dollars to pay for our excess of exports. We have been told by economists that foreigners could repay these loans only by exporting more goods to us than we exported to them. We were not willing to have our markets flooded with foreign goods, and consequently these loans have not been repaid. It is doubtful that private American citizens will throw good money after bad by making additional loans and investments abroad after this war. For this reason we do not see how we can have a favorable balance of trade after the war unless our Federal Government lends money abroad. We also fail to see how these loans could ever be repaid, and so they should be considered as a gift out of our generosity to needy foreigners. Obviously we are not likely to make such gifts year after year.

Additions to inventory are considered a faulty stone, because when inventories are built up above normal in 1 year they must be brought down to normal in a subsequent year by inventory liquidation. In 1929 we added $2,700,000,000 to business inventories. In the next 3

years inventories declined $5,500,000,000, an average of $1,800,000,000 per year. What goes up must come down. If we achieve prosperity by adding to inventories in 1 year, we thereby bring about depression in a subsequent year as these inventories are reduced to normal.

Mr. DAVIDSON. This is quite evident: If Uncle Sam after the war, has to carry the Federal debts, the foreign loans, and public works, it is only fair to say the billions required in industrial conversion and readjustment will be quite a burden if you are going to pass it along to those others.

Ever since the days that Joseph stored up grain in Egypt during the reign of Pharaoh, I believe business has endeavored, during the fat years, to build up reserves to take care of it during the lean years, and that was not difficult to do.

For instance, in 1929 the Federal taxes were only 11 percent. Of course, they did not say "only" in those days. That left 89 percent for expansion, for increased inventory, for the reserves for the lean years, and for dividends, and so it was perfectly possible to set aside reserves for lean years.

Under the proposed tax bill which you have before you, the rate for different corporations will be different according to what their excess-profits tax base is, but we figure in quite a number of cases the total tax rate will run as high as 87 percent. That will leave 13 percent for expansion, for increased inventory, for reserves for lean years, and for dividends.

Senator BARKLEY. Let me ask you something in regard to that figure in the left-hand corner. I understand you to say it was 11 percent of the total national income that was represented in taxes.

Mr. DAVIDSON. No, sir. This is the tax rate of the corporation. The corporation paid 11 percent on its income. This figure of 87 percent, of course, is theoretical. As a matter of fact, when you have an 87 percent theoretical general tax rate you have a much higher rate than that for many companies, and it has been proven that in some companies you have a rate of 107 percent, making it absolutely impossible for the corporations to lay aside the reserves for this readjustment after the war, such as the changing of machinery and working on new products, unless those reserves can be free from tax.

Senator TAFT. How does that 107 percent work? What is it that makes that possible?

Mr. DAVIDSON. Well, there are quite a number of items in that, Senator. There is a little booklet of about 6 or 8 pages written on the subject by Mr. Stam, that was printed and given to the Ways and Means Committee and to the press during their executive sessions, that is by far the best thing on the subject.

Mr. Stam, in his booklet, takes about eight pages to explain it. He shows why in England, for example, they found from actual experience that a theoretical rate of 80 percent in some cases meant a much higher rate.

I shall try to explain that very poorly. I should think, Mr. Chairman, it would be a good idea to have Mr. Stam's report on that subject included in the record here, if you are interested.

The CHAIRMAN. We will have it before us, Mr. Davidson.

Mr. DAVIDSON. If Mr. Henderson, Senator Taft, is successful in keeping the price rise down to only 10 percent—and I will certainly compliment him if he does that——

Senator BARKLEY. You mean from now on?

Mr. DAVIDSON. Yes.

Senator BARKLEY. It has already been 15 percent, since World War II began.

Mr. DAVIDSON. I mean from now on.

Senator BARKLEY. Yes.

Mr. DAVIDSON. Let us take the 90-percent rate; here is a corporation whose inventory prices are increasing at the rate of 10 percent a year. If its wages are increasing, it can deduct them from its taxable income, but its inventory increase cannot be deducted. Its replacement of machinery cost is also increasing 10 percent a year.

That goes along for several years and the war ends and we have deflation and prices come back to normal. Remember that at the close of each year when the corporation figures its profit, it does not figure profits on the basis of how much cash is left in the bank, but that the increase in inventory prices has resulted in a paper profit, and the corporation has to pay 90 percent of that paper profit out in taxes.

When the war is over and we come back to normal and the corporation needs that 10 percent, because prices went up and came down, they do not have it; 90 percent of this unrealized profit was paid out in cash, in taxes.

Also, many expenses, on an accounting basis, may not be deducted for tax purposes. This partially explains why the actual tax rate in many cases is higher than the rate stated in the law.

I believe that after the last war there was a commission or committee of Congress appointed to study the effects of the last war so we might be better prepared for the next time, and Mr. Arthur Ballantine testified before the committee that they had found 80 percent was the maximum rate that could be safely assessed against corporations, and gave reasons similar to those that I have just mentioned.

Here is how England solved the problem. The British Government admitted that when the excess-profits tax rate, or any rate exceeded 80 percent, it resulted in waste, inefficiency, extravagance, in reducing war production, and in losses for many corporations, and yet public opinion forced upon them a rate of 100 percent. So when they put the rate of 100 percent in effect, to satisfy public opinion, they at the same time, put into effect a post-war refund of 20 percent, because they knew that the corporations could not stand a higher rate than 80 percent (that was the way that they solved it); that 20 percent to come back after the war, believing that it will be used in stimulating business and resulting in avoiding unemployment.

For this purpose, the Treasury, when it first appeared before the Ways and Means Committee, suggested a credit to come back after the war equal to the excess over 80 percent, and, as they expressed it at that time, that whenever any dollar is taxed more than 80 percent that excess should be refunded after the war. Others who have studied the problem have recommended including not merely the excess profits over 80 percent, but also refunding a part of the income that is subject to normal tax of corporations, and also extending the post-war refund to individual income taxes.

Senator BARKLEY. Is not the net result of that, if the Government taxes 80 percent and then borrows all over that, if it is going to refund it, it is just a loan?

Mr. DAVIDSON. That is the net result. It is the same as if they paid 80 percent and then had bought non-interest-bearing bonds with the balance.

Yet it was the only solution that Great Britain could find, and, as you know, in England they have had about four times as much experience with excess-profits taxes as we have had. They have had quite a number of years of real experience.

Senator VANDENBERG. And experience with the war, also.

Mr. DAVIDSON. That is right.

Senator BROWN. Those bonds would not be payable or convertible until after the war?

Mr. DAVIDSON. Those bonds would not be payable or convertible until after the war.

As Senator Barkley said, it is the same as borrowing money until after the war, without interest.

In England, at the same time that they put into effect the 20-percent refund for corporations, that is 20 percent of the income subject to excess-profits tax, they also gave a similar provision to individuals, which meant borrowing money from individuals without interest, to be paid after the war.

We believe this; we believe that the memorandum prepared by Mr. Stam should be studied carefully. We believe the experience in Great Britain will indicate that if you have 90-percent taxes, such as in this present bill, without an adequate post-war reserve, that when the war is over and we have the deflation period, that corporations will die just like flies do at the end of summer.

Now, in endeavoring to find some automatic yardstick for determining which corporations would need most a reconversion fund, which corporations would have the greatest conversion problem, we found this interesting fact: The larger the percentage of a corporation's earnings that were subject to excess-profits tax, the greater that corporation's need for conversion after the war. That is not absolutely correct. Notice the aircraft industry, approximately 82 percent of its earnings are subject to excess-profits tax, more than any other industry, and we know that when the war is over the aircraft industry will have the greatest conversion problem.

As you come down here to the food, soft drink, and cigarette industries, those industries, when the war is over, will not have to throw out machinery, and put in new machinery, they will not have to change their plants, they will have an entirely different problem, and we find likewise that with them the percentage of income that is subject to excess-profits tax is much smaller.

So we found this, that on the English plan of having the refund based upon a percentage of the income that is subject to excess-profits tax, that that automatically provided—to a great extent—the largest fund for the corporations having the greatest conversion problem.

Gentlemen, it is not our desire or purpose to recommend any particular plan. We would like to point out some fundamentals which we believe are essential, and they are these:

First, we believe that the size of the fund should be at least a billion dollars a year. There are several ways of reaching that. The

14 percent, which was at one time in the House bill was sufficient, according to the Treasury, to produce $1,000,000,000 a year.

But that is not the only basis. A similar percentage, subject to excess-profits tax with a portion of the income subject to normal tax will also raise the same amount, and we think that $1,000,000,000 per year is the minimum if we really want to try to avoid unemployment when the war is over.

The second principle is that of certainty. Let me give you an example. The aviation companies will have the largest percentage of lay-off of labor of any industry, unless something is done about it. Some of these companies have blueprints on hand already for the production of flivver planes, and I think that when the war ends others will have similar blueprints. They will not have, however, the risk capital or venture capital required, and they will not have any place to get such risk or venture capital. They will be forced to let a large percentage of their men go; then they will probably produce a few samples and put the samples out and try to get orders, and when they get orders then they can borrow the money on those orders to produce the planes, probably a year or more after the hostilities cease.

If those companies have this post-war fund of risk capital or venture capital, then instead of letting their men go they can start producing those planes immediately and take a chance of their being able to sell them, and the chance is pretty good. They will have the capital that they could not get from banks or other places, and they can put their men to work immediately.

The point I am getting at is this: This certainly does not have any value if the corporations receive some kind of post-war certificate that they believe they can get money on after they have gone through about three courts. Under such conditions the plan would fail to carry out its purpose. That was why we suggested at the start, that at the time a corporation pays its tax, instead of after the war, at the time the corporation pays its tax, it should be given bonds, which are the same as any other United States bond, except that they are nonnegotiable and noninterest bearing.

By being nonnegotiable, you do not have to worry about the corporation spending the bonds before the war is over. They cannot spend them. By being noninterest bearing, the Government does not have to pay out any money during the war.

But if those bonds, when the war is over, automatically become negotiable or "assignable," as stated in the House bill, then they can be turned into cash. We think that they must have that element of certainty or else the plan is of no value whatsoever.

Now the next one is simplicity.

Senator TAFT. What about the end of the war? How do you know when that happens?

Mr. DAVIDSON. How do I know when the war ends?

Senator TAFT. Yes.

Mr. DAVIDSON. Senator, I was very much in hopes that that question would not be asked. There was an attempt, and I think a pretty good attempt made to draft such an explanation in the Ways and Means Committee bill when this provision was put in that measure.

Anyhow when that event as described in the bill happens then we want, from then on, the thing to be certain.

Senator VANDENBERG. When you talk about the end of the war, you mean when the armistice arises, you do not mean the ultimate peace that may come 3 years later?

Mr. DAVIDSON. Yes, sir; I think the wording given by the expert was "cessation of hostilities."

Senator VANDENBERG. That is quite different from the "end of the war" technically?

Mr. DAVIDSON. Yes; on this fundamental called "simplicity" I might mention that during the last war, when you had the excess-profits tax for the first time, we had a provision about invested capital. We have accounting rules that define "invested capital"; but, nevertheless, as you know, the courts have been trying ever since then to determine just what the invested capital of certain companies was.

Now, if we put a lot of restrictions around the use of these funds by the corporations, so that they have to go into court to find out whether the purposes they intend using them for will finally be upheld and they cannot use the funds as soon as the war is over, that would destroy the purpose.

Senator RADCLIFFE. Over on B, on the left-hand page, where you state, "Make bonds nonnegotiable until end of war," you suggest no limit on nonnegotiability.

Mr. DAVIDSON. None whatsoever. The idea being not only ours but of everybody in the various Government departments that after hostilities cease the sooner corporations start using these funds the better.

On this subject over here, in regard to the use of the funds after the war, the British Government decided there should be only one restriction, namely, they should not be paid out in dividends.

The American Federation of Labor—their official tax committee—wrote a letter to the various members of the Ways and Means Committee—and I have a copy of it here—and in this letter they suggested that with the exception of the money not being used for the payment of dividends, there should be no further restrictions, and in every case, it should be left to the discretion of the board of directors of each corporation. With your permission, I should like to have that letter inserted here.

The CHAIRMAN. Very well. It will be inserted.

(The letter referred to is as follows:)

AMERICAN FEDERATION OF LABOR,
Washington, D. C., May 19, 1942.

Hon. A. WILLIS ROBERTSON,
Member, Ways and Means Committee,
United States House of Representatives, Washington, D. C.

MY DEAR CONGRESSMAN: We, the members of the committee on taxation of the American Federation of Labor, urge upon you and the other members of the Ways and Means Committee, that you include in the taxation program that you now have under consideration plans which will aid in alleviating suffering from mass unemployment at the close of the war. We believe that prevention and alleviation of mass unemployment is fundamental to the preservation of our democratic political institutions as well as to individual initiative in the economic field.

Because of our well-known interest in promoting full employment at all times and in the preservation of democracy, we are vitally interested in planning now for post-war recovery and reemployment.

As a means toward this end in England, the British Government has agreed to refund to corporations after the war, 20 percent of the income of these corporations that is now subject to excess-profits tax. Unless this 20 percent

used in expanding business, the effect is merely to postpone the effective date of taxation. This will create a pump-priming fund which can be used for any business purpose except the payment of dividends and is intended to provide employment for those who are no longer engaged in war activities.

When this war ends there will be millions of laborers in this country who will need to change from war to peacetime employment and the American Federation of Labor would like to see something similar to the above-mentioned plan included in the tax bill which you are now preparing.

While we are primarily interested in principles, rather than details, we would suggest that the income be taxed to the corporations at the time received or used and be taxed at the rates then in effect. The British proposal that the use of the funds be not restricted except that they may not be used to pay dividends, seems advisable to us.

We respectfully urge that your committee make every effort to provide insofar as it is possible, against the need of future Federal appropriations for the sole purpose of providing "make work" for the future inevitable conversion unemployment.

Respectfully yours, (Signed) MATTHEW WOLL,
Chairman, Committee on Taxation, American Federation of Labor.

Mr. DAVIDSON. In the Ways and Means Committee, when the post-war provisions were put into the bill, these restrictions [pointing to chart] were also entered, and I myself see no particular objection to them, that is, that the funds may not be used after the war for the payment of cash or stock dividends; for the payment of taxes or salary increases of executives; increases to reserves unless employed in business, and increases of securities.

The next element we suggest as being essential is immediate action; that is, if you start this now and you find later that your fund is growing too large you can easily stop it, but if you wait to start it, it may not be large enough.

I should like to insert, along with that letter, also a letter that is on this next chart, from the national legislative committee of the American Legion on the same subject.

The CHAIRMAN. Very well; it will be inserted.

(The letter referred to follows:)

THE AMERICAN LEGION,
Washington, D. C., June 4, 1942.

Hon. ROBERT L. DOUGHTON,
Chairman, Ways and Means Committee,
House Office Building, Washington, D. C.

MY DEAR CONGRESSMAN DOUGHTON: As you know, for more than 20 years the American Legion has advocated a universal service plan, the purpose of this, of course, is to deprofitize war and it is our understanding the Ways and Means Committee is giving serious and studious consideration to this subject for inclusion in the forthcoming tax bill.

At the last meeting of our national executive committee an allied subject was considered—it is that some thought should be given to possible unemployment in the post-war years. It is our thought that prevention and alleviation of mass unemployment is fundamental to the preservation of our democratic political institutions.

It is our understanding that England, in planning now for post-war recovery and reemployment, has adopted a system of refunding to corporations, after the war, 20 percent of income of corporations, which income is subject to excess-profits tax. Unless this 20 percent is used in expanding business the effect is merely to postpone the effective date of taxation. This will create a pump-priming fund which can be used for any business purpose except the payment of dividends and is intended to provide employment for those who become unemployed in the transition from wartime to peacetime.

We respectfully urge that your committee give serious consideration to some plan whereby industry may be encouraged to prevent and alleviate mass unemployment in the post-war years.

Sincerely yours, (Signed) F. M. SULLIVAN,
Acting Director, National Legislative Committee.

Mr. DAVISON. Here is an unusual thing (pointing to chart). I was surprised when someone sent me this reprint from the Buffalo Federation of Labor Herald on June 19, because that reprint contains the chart which I have shown you, which was in a booklet we published and the written material was taken from that booklet.

I investigated and found, as stated in this advertisement that 20 local labor unions were enough interested in post-war recovery and reemployment to pay for a full-page advertisement in the newspapers.

Before this subject was discussed in any committee, Mr. Donald Nelson was speaking before the Naval Affairs Committee as a witness, and Mr. Nelson, being asked a question by Mr. Maas, said:

I do think there is going to be a tremendous cost of converting back from wartime to peacetime, and that somewhere there should be a reserve that will take care of that—perhaps in the shape of non-interest-bearing bonds of some kind which will mature when this thing is over.

Mr. Maas said:

Do you believe that industry would be perfectly willing to sacrifice any profit, especially if it was deferred until they needed it?

Mr. Nelson said: "I am sure of that, sir."

Now, I would like to explain right here that when I first discussed this subject in the Treasury, quite a long time ago, I said I did not believe that it would be possible to raise, through the tax bill, anything like the amount of revenue that this country needed during the war.

I do not believe that the tax bill, the tax provisions as recommended by the Treasury are anywhere near large enough. We also do not believe that this year the combination of revenue from your tax bill (when it is completed) plus the bonds that will be sold to individuals, will produce sufficient revenue.

In other words, we are afraid that the Government is going to be forced to sell more bonds to commercial banks than should be sold, if we wish to prevent inflation. Therefore we suggested about 6 months ago, that every effort should be made to secure, in revenue from corporations and from individuals, the largest possible amount.

Now we believe this, just as they did in England; if you have an excess-profit tax rate that is higher than corporations can stand and remain solvent and then you have a refund after the war through the means of these bonds, you can prevent that insolvency; you can prevent the difficulties and you can collect more revenue now.

Back in 1931 we were advisors to several banks and we said to those banks, "From now on until this thing is over just forget about making money. The question of making money is not important, the important thing for you is to remain solvent when this trouble is over, so that you can continue operating for many years thereafter."

And we have been saying recently to our client corporations, "Forget about making profits during the war. That is not important. The important thing to you, from a solvency standpoint, is to be in a solvent condition when this war is over, and be in a condition to continue to operate for many years thereafter."

Senator WALSH. Have some of them accepted your advice?

Mr. DAVIDSON. Yes, Senator. You might think I am joking or exaggerating, but we have also advised several of our clients to go

to the purchasing departments of the Government and voluntarily make refunds, and they have accepted that advice.

Senator WALSH. I have in mind the Du Pont Co. They have cut their dividends for that purpose.

Mr. DAVIDSON. I do not know about what the Du Pont Co. has done. Our corporations are the medium-size corporations. They are not listed on the stock exchange. They are corporations about the size of the Johnson Wax Co.—medium-sized corporations.

Senator WALSH. The same advice would apply to industrial companies that you recommended to the banks?

Mr. DAVIDSON. Yes, sir. We think while the war is on, corporations should not put first the making of profits. You may take away all of its war profits during the war, provided the corporation can have some reasonable assurance that when the war is over it will not be insolvent and that it can operate for many years thereafter.

Senator VANDENBERG. Does your advice regarding the elimination of profits go to the extent of eliminating normal dividends?

Mr. DAVIDSON. That would apply differently to different types of companies. Where the companies are owned by a family, such as most of the companies we represent are, and, as I say, we are advising the smaller, medium-size companies, we think even that could very well be done. If the company is owned by a family, the question of its dividends, we think, is not so important, while this country's like is at stake.

Regarding utility companies—and we do not have any connection with any utility companies—where such companies sold preferred stock to the widows and to trusts, and to all types of investment clients in their cities, sold them at 4 or 6 percent, and those people had reason to believe when they bought that preferred stock, that they were buying a sound investment security that would pay them dividends, that presents a different situation.

I lived in Louisville, Ky., for 30 years.

Senator BARKLEY. Why did you leave and come down here?

Mr. DAVIDSON. Well, Senator, I go back two or three times a year. I remember quite well when the Louisville Gas & Electric Co. sold its preferred stock—I think it was 6 percent—my mother was a widow, working for a living, and at that time she bought a little of that, about $200, I believe. I know other people of the same type all over the city who bought that class of security. They thought, as long as the people in Louisville used electricity or gas, either one or both, the stock, being preferred, was going to be good and would pay dividends.

Now, I should certainly hate to recommend that those companies should discontinue paying dividends at this time, but I think there are many closely held companies that could.

Senator TAFT. That ought to relate more to tax on normal profits than tax on excess profits.

Mr. DAVIDSON. That was the question that Senator Vandenberg asked.

Senator VANDENBERG. Yes.

Mr. DAVIDSON. Of course, every once in a while when we are told about some hardships in the tax laws, we are told that it is much worse over in England.

Well, you know, of course, that in Great Britain when the corporation pays out a dollar in dividends, it is relieved from paying normal tax on that amount and the war has not changed that at all.

Corporations in England are still able to pay out dividends on which they have paid no normal tax. We are not that fortunate.

Senator GERRY. That was true in the last war legislation, too. The normal tax was paid by the corporation.

Mr. DAVIDSON. In Great Britain?

Senator GERRY. Here.

Mr. DAVIDSON. Yes, sir.

Senator TAFT. You mean, in other words, we have a double tax on ordinary earnings, first on the corporation when it earns, and then when the common stockholder gets it?

Mr. DAVIDSON. That is right.

Senator TAFT. Whereas, in England there is at least some attempt to eliminate that duplication, to a limited extent, and we used to have such a plan, although it was different from the English, of course.

Mr. DAVIDSON. That is right.

Senator VANDENBERG. I just want to be sure I understood your statement.

You mean in forgetting excess profits you would not destroy the personal economy of this country by striking down the entire dividend policy in the normal operation of business on which millions of our people depend for their living?

Mr. DAVIDSON. You are certainly right, Senator.

I was thinking, when I answered, more of our problem.

When you get into publicly held corporations, let us say, those listed on the New York Stock Exchange, with their securities held widely, when you destroy the payment of those dividends, then you break down the economy of the country.

Although I am not any expert on that, in trying to answer your question I should say this: In taxing corporations we should take first, every dollar of the war profit. There is not any reason I know of why any corporation should say, "We are entitled to war profits," so I think you should first take all of the war profits before you make the normal tax so high that it places a real burden upon the existence of the corporation, after the payment of reasonable dividends.

But that is just my personal opinion.

Senator BARKLEY. Did you state, before I came in, the nature of the Fiduciary Counsel, Inc.? Is it a law firm that is incorporated?

Mr. DAVIDSON. I stated that, Senator, but I always love to tell what our business is. It is a financial research organization, Senator, furnishing financial and business advice to approximately 40 medium-sized corporations.

Mr. Ganson Purcell, Chairman of the S. E. C. last fall, before Pearl Harbor, along about September, made a speech a which he said:

> We cannot wait until all actual fighting is ended to take steps necessary to protect us from its after effects. The transition—from war production to peace production—will not just happen automatically.

That was several months before Pearl Harbor.

Now, we think that the problem is something like that of a snowball. There is a great difference between investment capital and risk capital. For example, the Johns-Manville Co., I understand,

during the last depression, spent all of its reserves plus $10,000,000 additional capital in risk ventures, in new products with the result that when the depression was over 85 percent of their sales came from products which were not in existence before the depression.

Now, as you men know, you cannot go to the banks and you cannot go to the investment houses and get that kind of capital. But we believe this, that any corporation that has these bonds when the war is over and uses this fund to increase its production, that means more jobs, that means more pay rolls, that means more purchasing power and that, in turn, means, of course increased production with more jobs, more pay rolls, more purchasing power.

So the snowball just rolls around and around. Just as soon as some of the new products become successful, the corporation will then be able to get all the investment capital that it needs for that operation.

Therefore, if we have over $5,000,000,000 in such a fund when the war is over to be used in new ventures, in risk propositions, that would magnify itself many, many times through investment capital, just as fast as those ventures become successful.

I have just two more charts and I will take only a minute on them. I want particularly to urge the importance of doing this now. In one department of the Government, when I talked on this subject, about 6 months ago, they said, "We agree with you that it has to be done, but there are so many things to be done this year that this does not have to be done this year."

This idea, of course, has been one of the great difficulties and one of the causes for the failures of the United Nations and this phrase describes it, "too little and too late." You remember what happened in Dunkirque, what happened in Greece, what happened in Crete, what happened in Yugoslavia, what happened in Singapore, Hongkong, and Manila. We remember those things, so we want to urge the importance of this thing being done this year and being done in this bill, so that we can get ready now to make the last shot of the war the starting gun for a post-war program.

I want to thank you very kindly for letting me have this time and attention.

The CHAIRMAN. Thank you very much, Mr. Davidson.

Senator TAFT. Mr. Davidson, may I ask one question about the reserves for inventory losses? Is there something in the bill now providing to take care of that situation, the profits that were not really profits because they represented inventory losses?

Mr. DAVIDSON. Senator, that is a very important subject. The Treasury made some recommendations on it and they can probably answer your question. I do not believe they had time to draft it and get it in the bill. I am not certain about that. I do not remember seeing it in the bill, but the Treasury can answer that, they have probably some representative here.

Senator TAFT. Some particular fund for refunding the 20 percent would not have any relation to that inventory question because some companies might have a big inventory and some companies have none at all.

Mr. DAVIDSON. That is a separate problem. There is another reserve which is essential, that is the wage-severance reserve, when em-

ployees are laid off. There are various reserves that are open for discussion, but I have discussed just one.

Senator DAVIS. Machines working 8 hours a day do not wear out as much as machines working 24 hours a day. Should not the amount of usage be considered in the determination of depreciation? Should this not be written into the law?

Mr. DAVIDSON. I am not an expert on the subject of depreciation but I think that consideration in the preparation of this tax bill could very profitably be given to the subject of increasing the rate of depreciation under the circumstances you mentioned. A similar problem exists where machinery formerly used for the production of civilian goods has been stored away in the hopes that it can be used for the same purpose after the war. Much of this machinery will then be obsolete.

Senator DAVIS. Many firms will be completely idle for the duration. Do we propose to tax them on their machines while they are idle and becoming obsolete?

Mr. DAVIDSON. I do not know that I understand your question completely. If the corporations are idle and not earning any profit, the only Federal tax which they will pay will be the capital-stock tax.

Senator DAVIS. If excess profits are to be taxed 100 percent, with a refund of 20 percent after the war is over, what is the base line for excess profits?

Mr. DAVIDSON. I assume that you are referring to the base which separates a so-called normal profit from excess profits. It is extremely important that the section of the law which controls this base shall not include in excess profits, profits which would have been made without any assistance from the war economy. The higher the excess-profits tax rate, the more important this is and and if Congress enacts a rate of 100 percent, the necessity for a fair and proper base is more essential than it would be under a 90-percent rate.

Senator DAVIS. Will each company be permitted to hold its reemployment reserves? Under what conditions?

Mr. DAVIDSON. It is absolutely essential that each corporation be permitted to hold its own reemployment reserves. When the war ends, the aviation industry, the machine-tool industry, and many other industries, will, without such reserves, begin operating in the red immediately. It is essential, therefore, that these companies make plans in advance for production which will result in continuing the jobs for their employees immediately after the cessation of hostilities. The plans will be of no value unless they also have at the same time the capital to enable them to carry out the plans.

We suggested that this could be accomplished best by giving the corporations bonds now which are nonnegotiable but which would automatically become negotiable, and in every other respect the same as all other United States bonds, immediately upon the cessation of hostilities.

Senator, I had some questions and answers which I gave the stenographer, which are the usual questions we are asked, and if I may, I would like to have them inserted in the record.

The CHAIRMAN. Yes, sir; they will be inserted in the record.

(The charts and the questions and answers referred to are as follows:)

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

A TAX PROGRAM

NOW

to stimulate post-war

RE-EMPLOYMENT

and

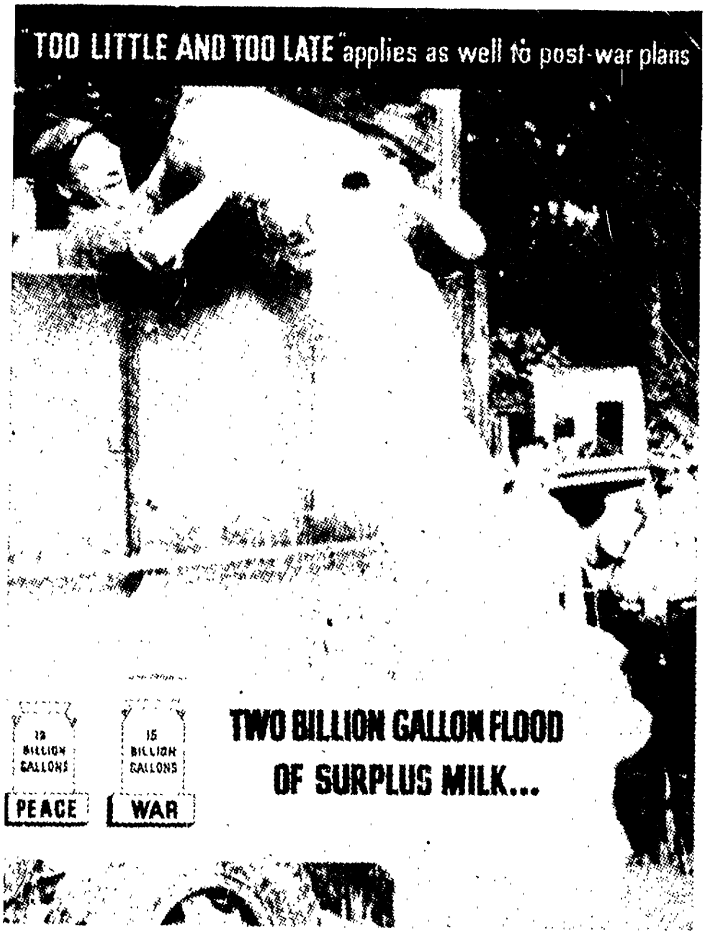
RECOVERY

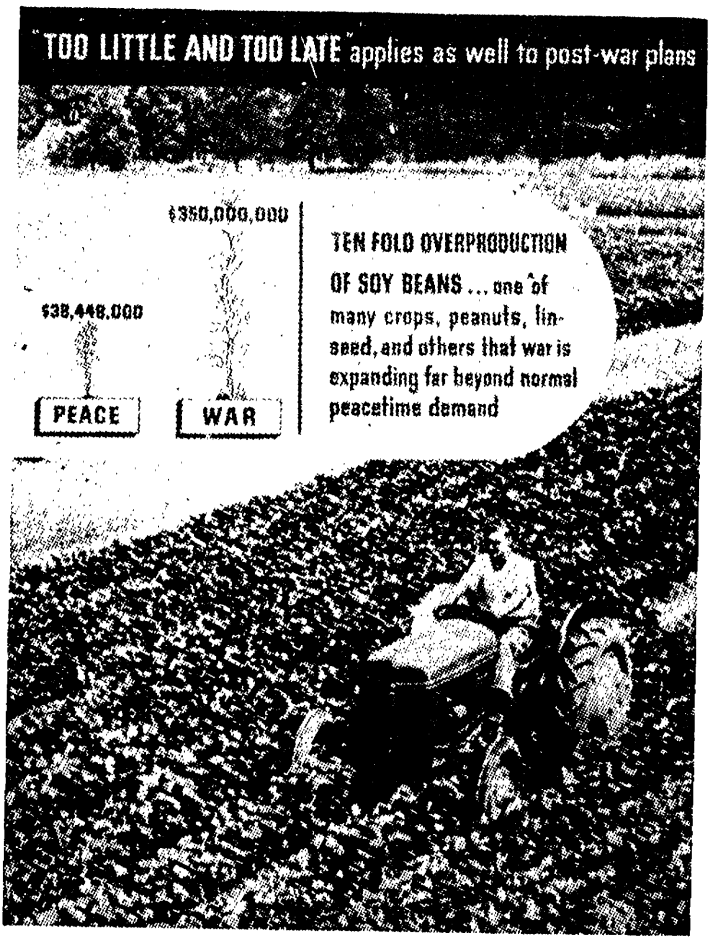
TOO LITTLE AND TOO LATE applies as well to post-war plans

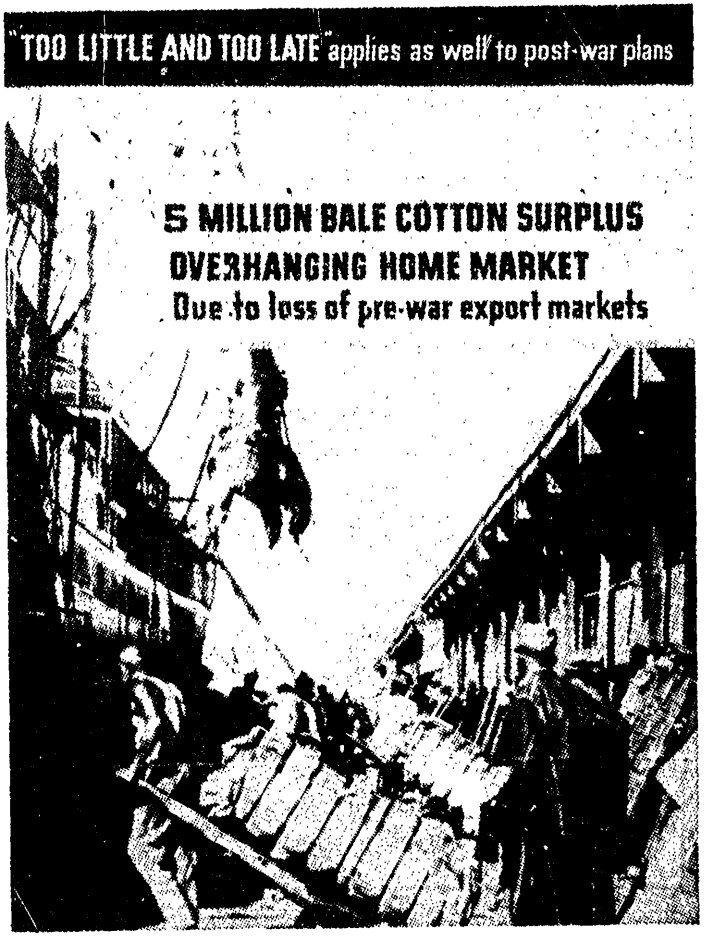
Over-Production
THE FARM TRAGEDY
OF POST-WAR U.S.

Unless we find new outlets, and maintain employment in our home market.



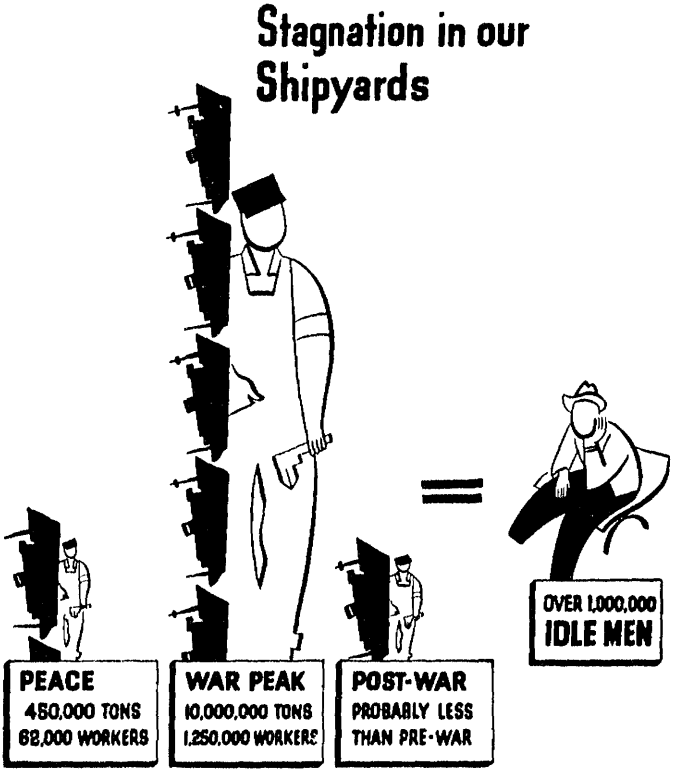

"TOO LITTLE AND TOO LATE" applies as well to post-war plans
12 BILLION GALLONS
PEACE
15 BILLION GALLONS
WAR
TWO BILLION GALLON FLOOD OF SURPLUS MILK...

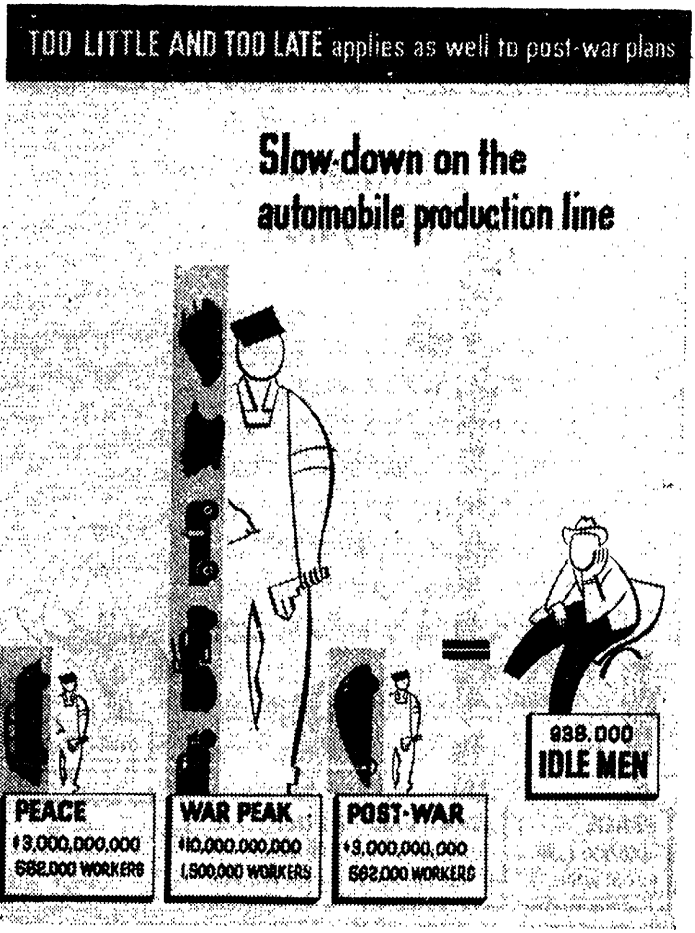

TOO LITTLE AND TOO LATE applies as well to post-war plans
$350,000,000
$38,448,000
PEACE
WAR
TEN FOLD OVERPRODUCTION
OF SOY BEANS ... one of many crops, peanuts, linseed, and others that war is expanding far beyond normal peacetime demand

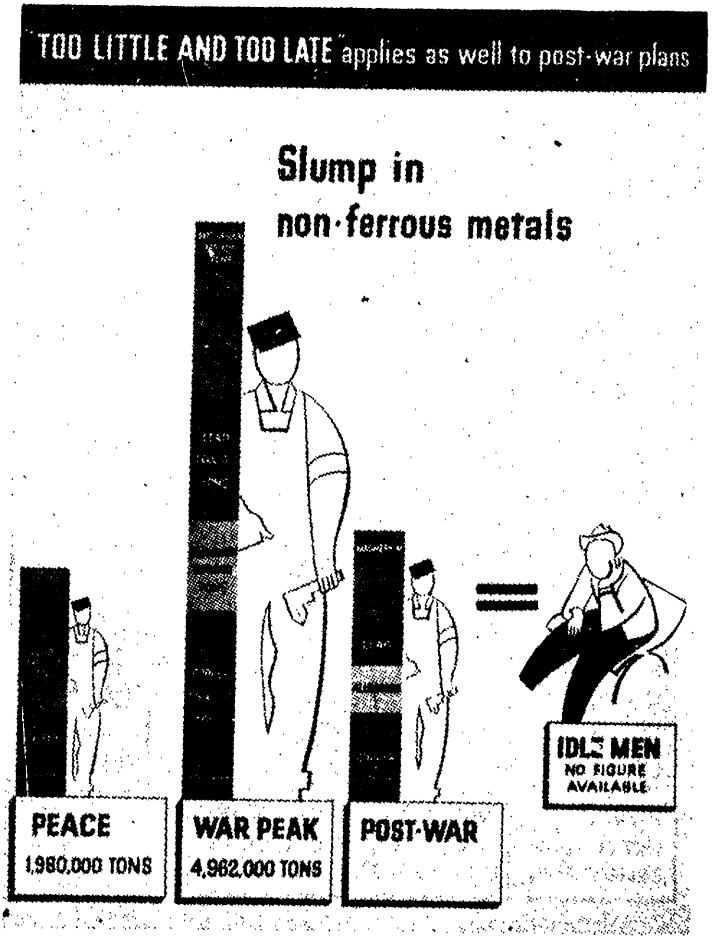

TOO LITTLE AND TOO LATE applies as well to post-war plans
5 MILLION BALE COTTON SURPLUS
OVERHANGING HOME MARKET
Due to loss of pre-war export markets


"TOO LITTLE AND TOO LATE" applies as well to post-war plans
Our Export Markets Will Be Ex-Markets
Europe will no longer be able to buy 40% of U.S. Exports
AMERICAN INVESTMENTS SPENT FOR MUNITIONS
LOST SHIPPING EARNS NO FREIGHT CHARGES
FOREIGN COLONIAL PRODUCTS REPLACED BY U.S. SUBSTITUTES

"TOO LITTLE AND TOO LATE" applies as well to post-war plans




TOO LITTLE AND TOO LATE applies as well to post-war plans
Slow-down on the automobile production line
PEACE
$3,000,000,000
662,000 WORKERS
WAR PEAK
$10,000,000,000
1,500,000 WORKERS
POST-WAR
$9,000,000,000
662,000 WORKERS
938,000
IDLE MEN

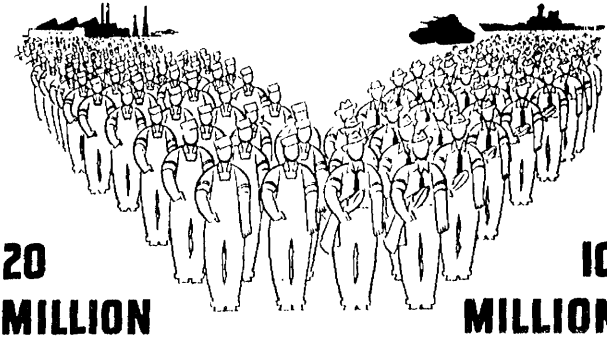

TOO LITTLE AND TOO LATE applies as well to post-war plans
Slump in
non-ferrous metals
PEACE
1,980,000 TONS
WAR PEAK
4,962,000 TONS
POST-WAR
IDLE MEN
NO FIGURE
AVAILABLE


"TOO LITTLE AND TOO LATE" applies as well to post-war plans
Aircraft Industry in a "stall"
PEACE
$107,000,000
24,000 WORKERS
WAR PEAK
$9,000,000,000
1,700,000 WORKERS
POST-WAR
$1,000,000,000
200,000 WORKERS
=
1,500,000
IDLE MEN

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

THIS V WON'T STAND FOR VICTORY

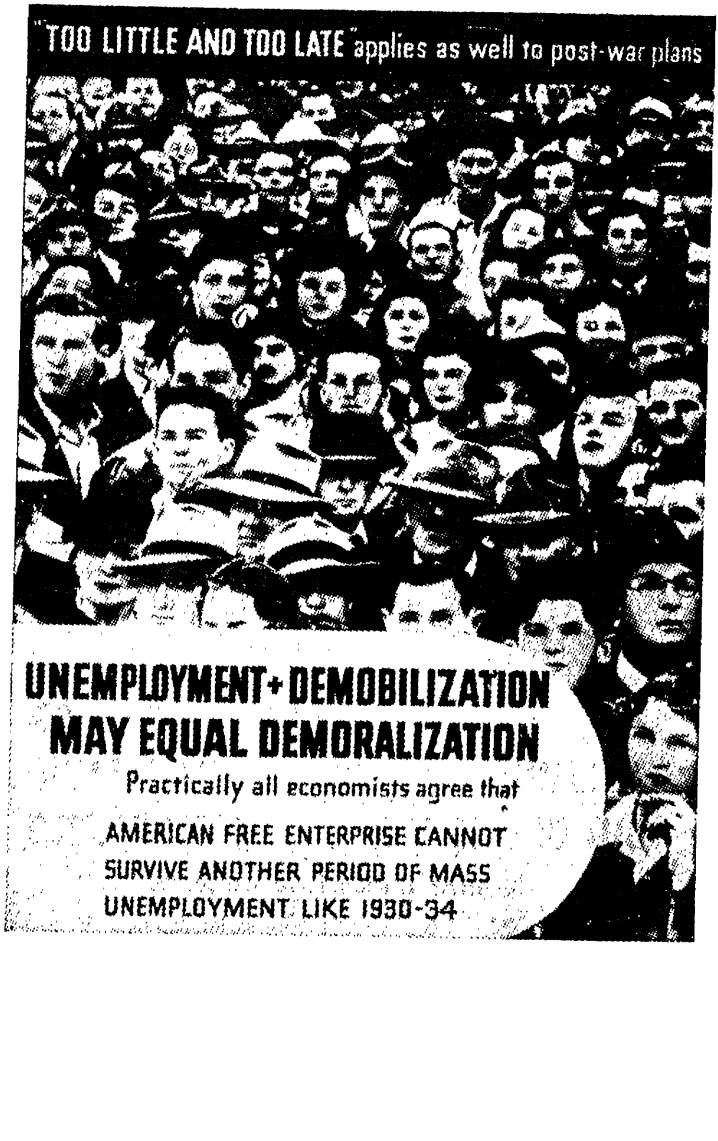
unless we plan now for post-war jobs

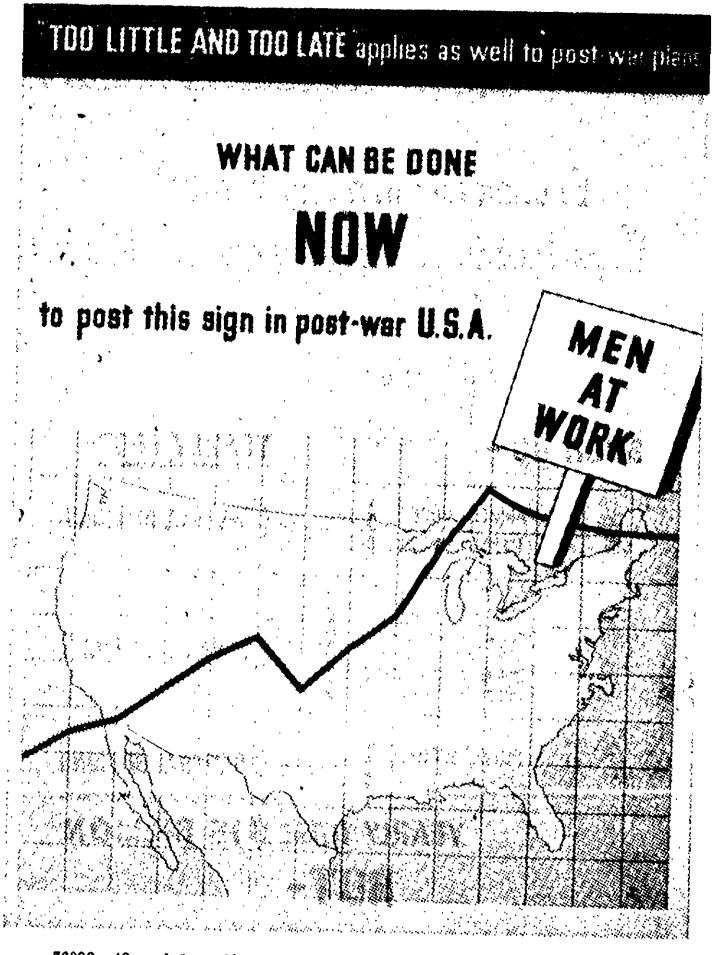


20 MILLION OUT OF WAR JOBS

10 MILLION DEMOBILIZED

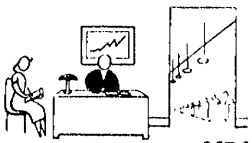
18 million may find no work


"TOO LITTLE AND TOO LATE" applies as well to post-war plans
UNEMPLOYMENT + DEMOBILIZATION
MAY EQUAL DEMORALIZATION
Practically all economists agree that
AMERICAN FREE ENTERPRISE CANNOT
SURVIVE ANOTHER PERIOD OF MASS
UNEMPLOYMENT LIKE 1930-34


"TOO LITTLE AND TOO LATE" applies as well to post-war plans
WHAT CAN BE DONE
NOW
to post this sign in post-war U.S.A.
MEN AT WORK

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

Economists in many Federal Departments are drafting Post-War Plans



such as – **YEARLY COST**



ARMED FORCES TO POLICE WORLD } —— $ SEVERAL BILLIONS



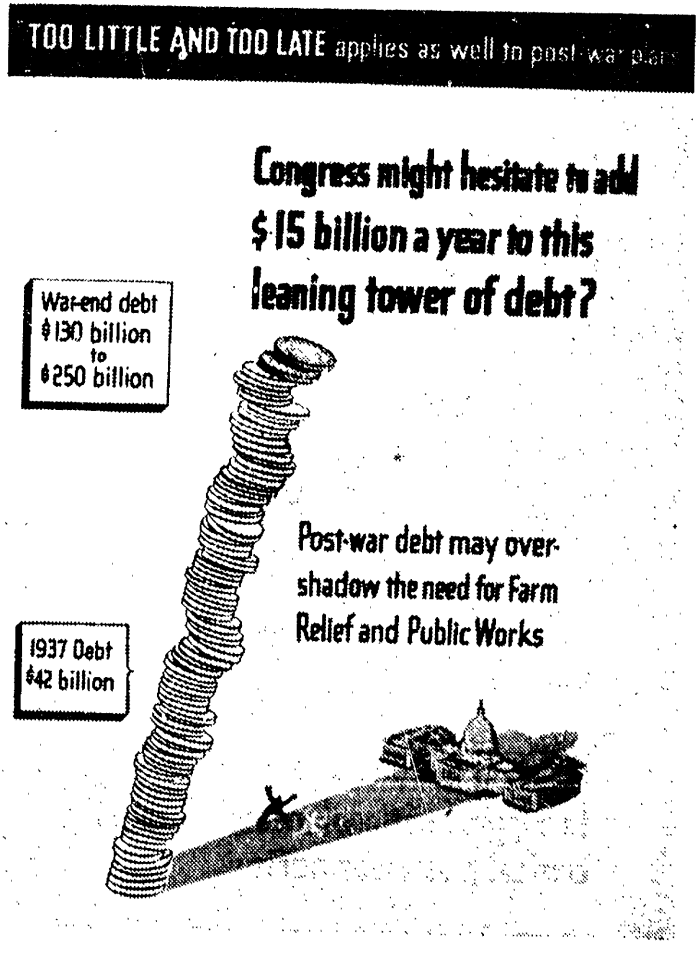
FOREIGN LOANS to revive markets for American goods - and be repaid in some manner as previous war loans and post-war loans. } —— $ SEVERAL BILLIONS



PUBLIC WORKS such as WPA, CCC and NYA. } —— $ SEVERAL BILLIONS

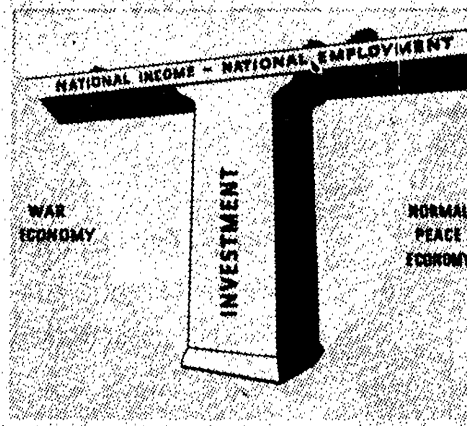
YEARLY TOTAL $ 15 BILLION

BUT-


TOO LITTLE AND TOO LATE applies as well to post-war plans
Congress might hesitate to add $15 billion a year to this leaning tower of debt?
War-end debt $130 billion to $250 billion
1937 Debt $42 billion
Post-war debt may overshadow the need for Farm Relief and Public Works

TOO LITTLE AND TOO LATE applies as well to post-war plans

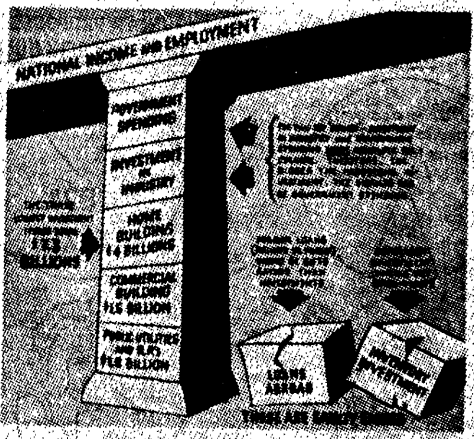
Somehow we must bridge the chasm between war and peace



We must build an investment column to support national income during the critical post-war period.

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

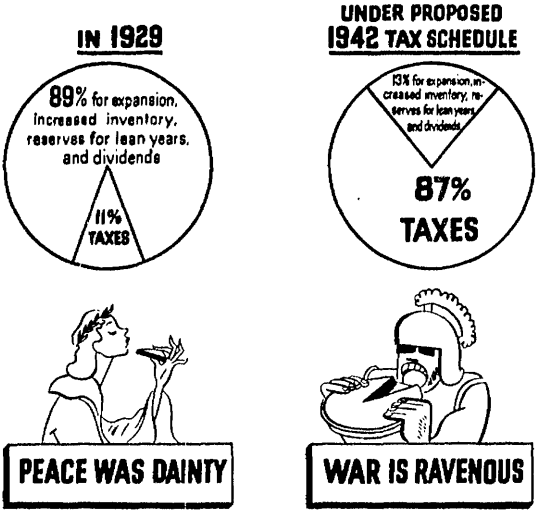
Here are the stones with which we must build the investment column



TOO LITTLE AND TOO LATE applies as well to post-war plans

In what position is industry, today, to set up post-war Recovery Reserves?

Here is the typical division of an earnings dollar of large corporations...

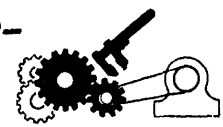


"TOO LITTLE AND TOO LATE" applies as well to post-war plans

HOW ENGLAND SOLVES THE PROBLEM

TAXES ABOVE 80%—

—interfere with war production



—cause corporate casualties



SO BRITAIN BALANCES HIGH WAR TAXES WITH POST-WAR REFUND



PUBLIC OPINION DEMANDS 100% EXCESS PROFITS TAX

ALL ABOVE 80% WILL BE REFUNDED TO CORPORATIONS FOR POST-WAR RECOVERY

MR. STAM'S printed memorandum demonstrated the logic of Britain's course.

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

OTHER SUGGESTIONS:

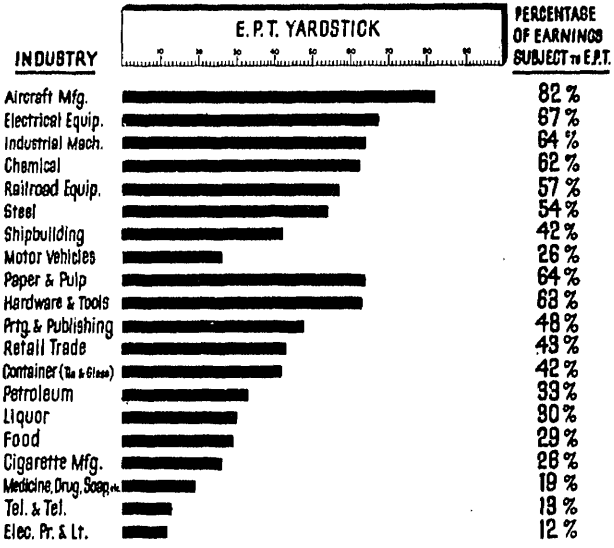
Treasury recommended Post-War Recovery and Re-employment reserve for corporations, consisting of all Excess Profits Taxes they paid above 80%.

Others recommend including part of corporate normal tax in reserve – and extending the post-war refund to individual income taxes.

A 90% Tax without adequate reserve will cause corporations to die like flies in post-war period-spreading depression and unemployment.

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

THE EXCESS PROFITS TAX IS TO SOME EXTENT A YARDSTICK OF POST-WAR CONVERSION NEEDS



Isn't this also the approximate order in which these industries are being forced into wartime overexpansion?

Isn't it a reasonable index of the relative need of these industries for post-war plant conversion to keep up employment?

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

WE WILL BACK ANY POST-WAR PLAN

1. **SIZE.** At least $1 billion a year should go into Post-War Reserve...14% of E.P.T. will do it.

2. **CERTAINTY.** The moment war ends, Post-War Reserve should be in hands of corporations -ready tu go into action.

   A. Issue corporation Special U.S. Bonds now-based on revenue subject to E.P.T.*

   B. Make Bonds non-negotiable until end of war-thus keeping Reserve intact for Post-War job.

   C. Make Bonds non-interest-bearing until after War, so that Government will not pay out one cent now needed for Victory.

* Same plan can be extended to the normal tax income of corporations and to taxable income of individuals

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

WITH THESE ESSENTIALS IN IT

3. SIMPLICITY. Avoid all technicalities and uncertainties that might delay putting men to work after the war. Reserve should be available for all purposes except –

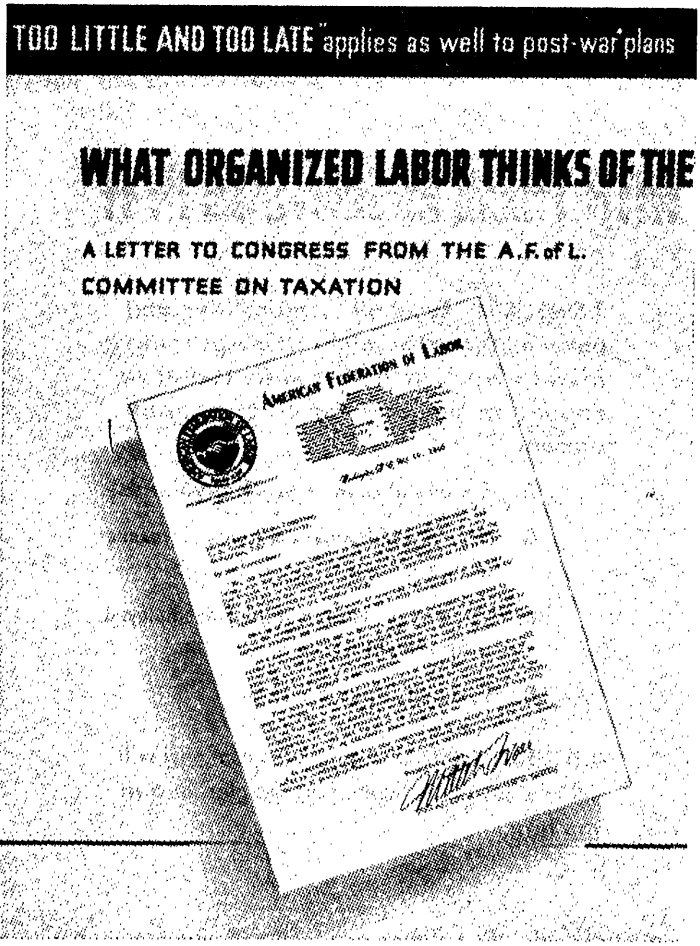
A. Payment of cash or stock dividends.

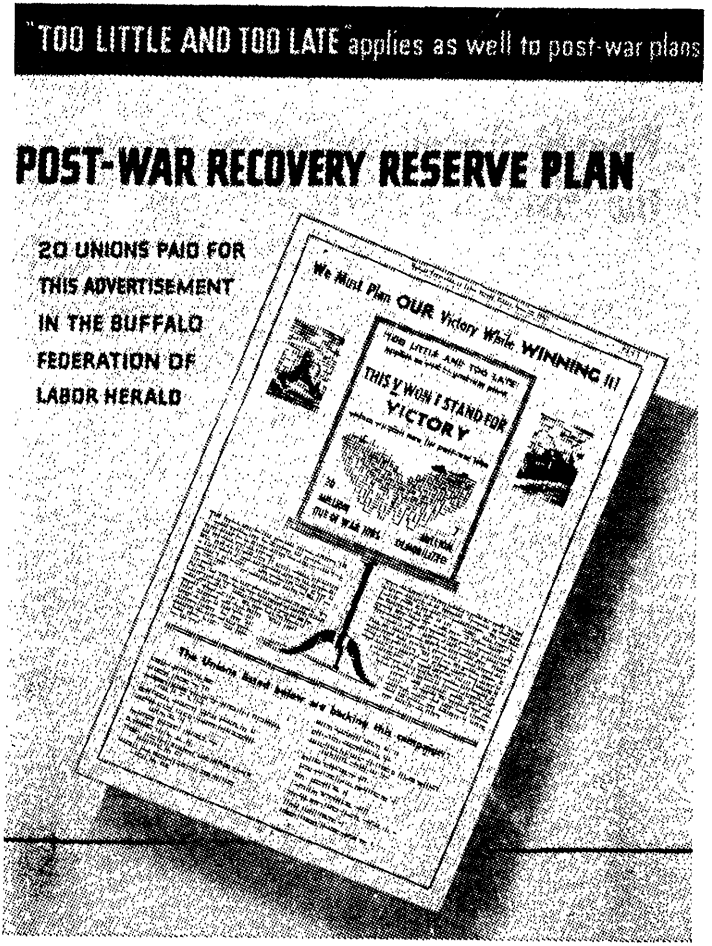
B. Payment of bonuses or salary increases to executives.

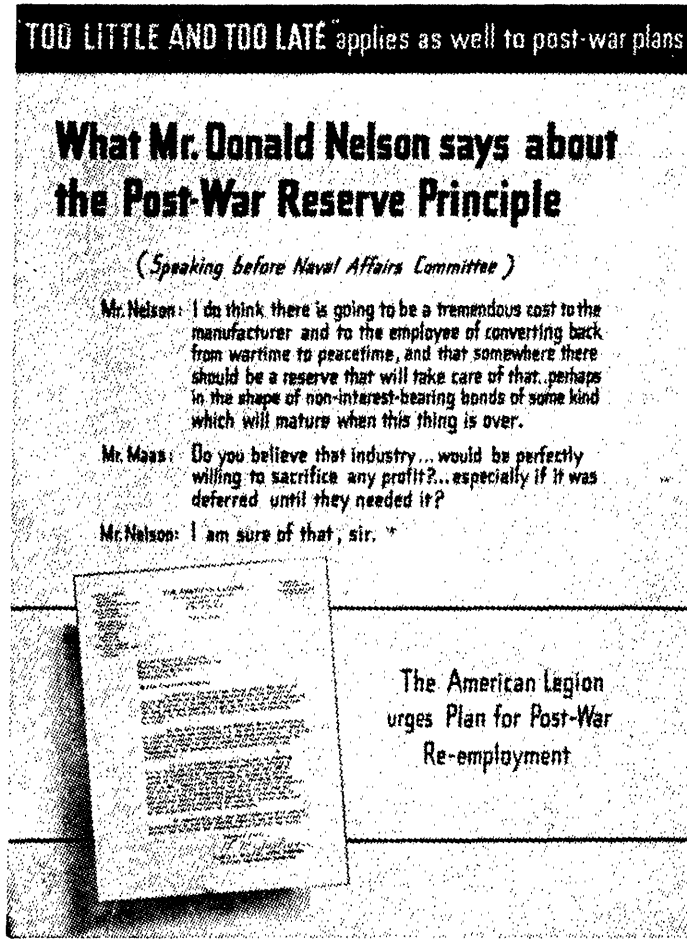
C. Increasing cash reserves, unless employed in the business.

D. Purchase of securities.

4. IMMEDIATE ACTION. A good program now will achieve far more than a perfect plan begun too late.


TOO LITTLE AND TOO LATE "applies as well to post-war plans
WHAT ORGANIZED LABOR THINKS OF THE
A LETTER TO CONGRESS FROM THE A.F. of L.
COMMITTEE ON TAXATION
American Federation of Labor


"TOO LITTLE AND TOO LATE" applies as well to post-war plans
POST-WAR RECOVERY RESERVE PLAN
20 UNIONS PAID FOR THIS ADVERTISEMENT IN THE BUFFALO FEDERATION OF LABOR HERALD
We Must Plan OUR Victory While WINNING It!
TOO LITTLE AND TOO LATE
THIS Y WON I STAND FOR VICTORY
The Unions listed below are backing this campaign!

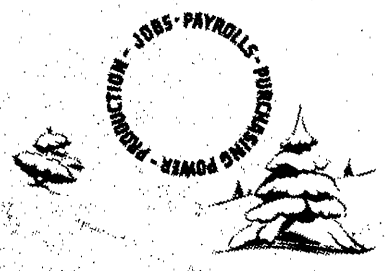

TOO LITTLE AND TOO LATE applies as well to post-war plans
What Mr. Donald Nelson says about the Post-War Reserve Principle
(Speaking before Naval Affairs Committee)
Mr. Nelson: I do think there is going to be a tremendous cost to the manufacturer and to the employee of converting back from wartime to peacetime, and that somewhere there should be a reserve that will take care of that...perhaps in the shape of non-interest-bearing bonds of some kind which will mature when this thing is over.
Mr. Maas: Do you believe that industry... would be perfectly willing to sacrifice any profit?...especially if it was deferred until they needed it?
Mr. Nelson: I am sure of that, sir.
The American Legion urges Plan for Post-War Re-employment

"TOO LITTLE AND TOO LATE" applies as well to post-war plans

MR. GANSON PURCELL, Chairman of S.E.C., said:

"**WE CANNOT WAIT** until all actual fighting is ended to take steps necessary to protect us from its after effects. . . . The transition (from war production to peace production) will not just happen automatically."

BUT post-war recovery, once begun, can go forward and grow automatically - like a snowball rolling down hill. The job is to start the nucleus of our snowball - the Post War Reserve. Get it over the brink of the hill. Start it rolling! Start it growing! start it **NOW!**




"TOO LITTLE AND TOO LATE" applies as well to post-war plans
LET'S GET READY NOW TO MAKE THE LAST SHOT OF THE WAR THE STARTING GUN FOR A POST-WAR RECOVERY PROGRAM !

QUESTIONS AND ANSWERS

1. Will banks be able to lend on recovery bonds?

Yes; exactly as they would on any other Government bonds. When a bank makes such a loan, it simply sets up a deposit on its books for the borrower. The only limit on bank deposits is the law stating what proportion of cash banks must keep on hand in relation to deposits. Since 1936, this percentage has been exceedingly high. It would only be necessary, after the war, to return to the 1936 limitation in order to permit a $50,000,000,000 increase in bank lending power—many times more than the recovery bond total.

2. Will banks be able to buy the recovery bonds?

Yes. Here again, when a bank buys a bond, it simply enters a deposit on its books for the seller. In 1941, with business booming, and plenty of calls for bank funds, United States banks had no difficulty absorbing $2,000,000,000 in bonds. They should have even less difficulty after the war. However, in case of need we can instantly expand the available bank credits by $50,000,000,000 simply by returning to the cash requirement law of 1936. Furthermore, Federal Reserve banks can expand their bond purchases almost indefinitely.

3. Would private investors buy recovery bonds?

Yes. Private savers and investors provide a ready market for these bonds. We shall acquire very thrifty habits before this war is over; and we shall probably carry over a great deal of that thriftiness into the post-war period. Even in 1932, savers amassed $5,000,000,000. In 1941 they saved $15,000,000,000. It is reasonable to assume the post-war savings rate may be somewhere between the two. The problem will be to find enough investments able to attract these savings. In such a period of uncertainty, timid investors might hesitate to buy private bonds. But bonds with the taxing power of the Federal Government behind them always command a ready market among the most conservative. Recovery bonds should be especially attractive, since the money would be used to stimulate private business.

4. How can 18,000,000 jobless be forecast?

According to War Production Board figures, peace will end the jobs of 20,000,000 war workers. According to the Office of Facts and Figures, we shall have to demobilize at least 7,000,000 men from our armed forces. It is impossible to say now how many of these will find prompt employment. How many will go back to the farm. How many of the women will return to their homes. How many of the oldsters will return to the retirement from which war wages or patriotism drew them.

But there is another method of reaching a conservative estimate of post-war unemployment. All the economic omens indicate that, if business takes its previous "do nothing" attitude, production soon after the war will drop to below the 1932 level. In 1932, we had jobs for 28,000,000 in business and industry, and for 11,000,000 more on the farms. Total, 39,000,000.

Now, assume the war ends in 1945. By that time, our growing population will give us a labor supply of 57 million. Say the job supply is the same as in 1932, or 39 million. (An optimistic forecast, unless we plan more effectively than ever before.) We shall then have 18 million idle—50 percent more than in the blackest days of what we have hitherto called "the Great Depression."

5. Why won't this peace bring a buying boom, as in 1919?

We may have a temporary buying boom. But building up our war-depleted inventory of consumer goods would only delay depression. Moreover, consumers may lack the purchasing power for large scale buying. And they are also apt to be more wary of over-spending than in 1919. For example, the late 1930's brought no buying boom, even after depression had depleted our stock of consumer goods.

6. If the bonds are used soon after peace, won't they be wasted during the possible post-war buying boom? When this boom ends may not the bonds be gone?

It is hard to imagine a post-war buying boom of more than 18 months. By then, the plant investment and the new products made possible by recovery bonds will be producing their real effect. They may extend the buying boom into a long-term upswing, and thus bring true prosperity to the Nation.

7. Will the recovery bonds be enough to reverse the post-war downtrend?

Should the war end in 1945, these bonds will immediately place in the hands of management some $4,000,000,000 (beside normal depreciation reserves) to convert our war production machine and launch new products. Business had no such fund in the early 1920's. Yet, because business was bold and ingenious, it

created prosperity. Who would have supposed in the war boom year of 1915, that the rate of industrial investment would double by 1923, or triple a few years later? With recovery bonds to encourage management after its long experience of depression and war, we may yet see economic history repeated—with prosperity and full employment in post-war America.

The CHAIRMAN. Mr. Cowan.

STATEMENT OF NATHAN E. COWAN, REPRESENTING THE CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. COWAN. Mr. Chairman and members of the committee: I just want to state I am appearing here this morning on behalf of Mr. Murray. He had originally intended to come. He asked me to read this statement.

The CHAIRMAN. Yes, sir.

Mr. COWAN. The tax bill now before your committee is the most important tax measure in our Nation's history. Our country is at war with a desperate and powerful enemy, whose offensive against ourselves and our Allies increases hourly the danger to everything our people cherish.

To meet this offensive, and to open offensive action of our own, we must mobilize every resource our Nation possesses; our economic and financial strength no less than our manpower and our industrial production. At the same time, we must see that the home front remains strong and secure, unweakened by inflation or other economic disasters.

The tax bill is a central part of this economic front for victory. It must be a tax bill that raises the amount of revenue our country needs. It must be a tax bill that strengthens the economic and financial fabric of the Nation. It must be a tax bill that draws revenue from those sources that can pay it without weakening their own war effort. It must be a tax bill written with one thought in mind—how best it can contribute to victory.

The President of the United States, in his seven-point message to the Nation, asked for such a tax bill as a keystone in gearing the country's economy to war. The United States Treasury laid down in detail the kind of tax bill that would meet those specifications. The 5,000,000 American men and women of the C. I. O. gave their full approval and support to the President and to the Treasury in their taxation proposals.

The United States Treasury called for taxes based on ability to pay, for an end to certain scandalous loopholes that permit the wealthy to evade their fair share of taxes, for certain increases in taxes on war profits and incomes, and for strict avoidance of the sales tax as a danger to the war effort.

The C. I. O. fully agreed with these proposals, adding only its opinion that the tax bill should seek to raise $10,000,000,000 rather than the 8.5 billion asked by the Treasury. In testimony before the House Ways and Means Committee and in repeated public statements, leaders and members of the C. I. O. have warned of the dangers to workers' health and living standards, and consequent cuts in war production, if the sales tax is adopted. I do not wish to present a detailed analysis of our opposition to the sales tax today. Briefly, it is this:

1. The sales tax is a menace to war production, since it cuts already meager living standards, increases the already steep cost of living, thus forcing production workers to reduce the amount of food and other basic necessities they consume and thereby reducing their health and efficiency.

2. It is the most unfair and undemocratic tax system that could be devised, since it takes the same tax from the budget of the poor as it takes from the budget of the rich.

3. It is invariably the result of a refusal on the part of those who draw tax legislation to do their duty in placing the tax burden where it belongs—on the shoulders of those best able to bear it.

The working men and women of America are willing to pay their fair share of the cost of victory through added taxes. They know how terrible would be the cost of defeat. They are already paying a large portion of their earnings in taxes, either direct or hidden. On an income of $1,500 a year, a married worker already pays $250 in taxes, the equivalent of 8 weeks' wages. Single workers pay more. The working men and women of this country are not trying to evade taxation. They are not seeking to perpetuate the shame of special privileges, of tax-exempt securities, of separate returns, and similar means of avoiding their patriotic duty. They have no special privileges to defend, and they ask for none.

When the workers appear before a congressional committee to urge support of the Treasury's proposals and to urge that the tax plank of the President's message be carried out, they come with clean hands and with sincere conviction. Their interest is in only one direction; to see that the 1942 tax bill becomes an instrument of victory for our cause.

Your committee has a great responsibility before it. It has also a great opportunity—the opportunity and the duty to repair the damage done to the Nation's economic front by the House Ways and Means Committee's version of the bill.

The bill as written by the Ways and Means Committee and passed by the House, under gag rule, fails miserably to carry out either the President's tax program or the reasonable and necessary proposals of the Treasury.

It is short close to 2.5 billions of the amount the Treasury asked for.

It fails to place taxes on the basis of ability to pay, following a soak-the-poor line throughout.

It fails to close the loopholes of tax-exempt securities, of separate returns.

It resolutely ignores the President's call for a $25,000 limit on net income, treating it as something that should not be mentioned in polite society, as though it were slightly indecent.

It utterly fails to carry out the principle of equality of sacrifice for victory, thus striking a serious blow at national unity and national morale.

It paves the way for a second tax bill this year, leaving the propagandists of the sales tax an excellent opening for renewing this anti-labor, anti-victory agitation.

It furnishes excellent material for subversive agents and other enemies of the war effort to use in divisive propaganda and anti-war agitation.

It does nothing to prevent inflation. Indeed, it helps promote inflation by leaving huge sums of money in the hands of the wealthy, who will thus be able to bid up prices on necessities and other goods.

In addition to its positive faults, the bill as passed by the House is a serious reflection upon the democratic process we are fighting to preserve. It does not represent the views of the House, since it was passed under a gag rule that prevented amendments and effective debate. It represents the views and personal interests of a handful of Congressmen dominating the Ways and Means Committee and their allies in the Rules Committee.

In this way, the voice of the people—who want an effective tax bill—was gagged, just as the 415 Congressmen outside the Ways and Means Committee were gagged.

Speaking for the C. I. O., whose 5,000,000 members I represent, I can assure you that the people of this country want a tax bill that will raise all the added revenue we need for victory, that will raise it in the quickest, most efficient way, and that will strengthen rather than weaken the economic front.

I urge your committee, therefore, to report out and to do its utmost to secure the adoption of a 1942 tax bill based on these principles:

1. Raising at least the amount of added revenue asked by the United States Treasury.
2. Ability to pay.
3. An end to loopholes that allow the wealthy to evade their duties to the Nation, particularly the loopholes of tax-exempt securities and separate income-tax returns.
4. Stiff taxes on war profits and high incomes, to a level at least of that proposed by the United States Treasury.
5. A limit of $25,000 on personal incomes.
6. No sales taxes of any kind.

Such a bill can be drawn up by this committee. In doing so, you will have made a major contribution to the victory that all our people desire above everything else.

The CHAIRMAN. Thank you very much, Mr. Cowan.

(The following statement was submitted by Mr. Murray:)

STATEMENT OF PHILIP MURRAY, PRESIDENT OF THE CONGRESS OF INDUSTRIAL ORGANIZATIONS, WITH RESPECT TO THE REVENUE BILL OF 1942 (H. R. 7378)

The President's seven-point anti-inflation program is in danger. The House tax bill has distorted and twisted beyond recognition plank No. 1, the tax plank, of the seven-point program. The tax bill endangers the entire anti-inflation front, for, as President Roosevelt has stated, "Each one of these points is dependent on the others if the whole program is to work."

Labor has accepted wage stabilization. Labor has called for all-out rationing and price ceilings. Labor has bought and is buying millions upon millions of dollars in war bonds. We accepted this program on the word of the President that it was necessary on the home front, and that it was "indivisible."

We now renew that acceptance. We challenge all who have not accepted it to follow our course. We propose that Congress enact plank No. 1 in the President's anti-inflation program.

To do so requires substantial modification in the tax bill adopted by the House, for that bill does not measure up to the standards of taxation enunciated by the President in his seven-point anti-inflation program. It does not "make the tax program an instrument of victory." Instead of forging a tax bill which would spread the burden with fairness and equality, the House has imposed a disproportionately large portion of the tax burden upon the lowest income groups in the country, while at the same time perpetuating loopholes and tax exemptions. The House bill constitutes a grave threat to the morale and physical well-being of the civilian soldiers producing the arsenal of democracy.

SUMMARY OF PRINCIPAL DEFECTS OF THE BILL

The House bill fails to meet the basic requirements of a revenue act for America at war:

(1) The House bill fails to provide adequate revenue. It falls nearly $2,500,000,000 short of the $8,700,000,000 additional revenue sought by the Treasury.

(2) The House bill fails to follow the democratic principle of taxation according to ability to pay. It reflects a soak-the-poor-spare-the-rich policy.

(3) The House bill fails to carry out the proposal made by President Roosevelt in his seven-point anti-inflation program that "No American citizen ought to have a net income, after he has paid his taxes, of more than $25,000 a year." It thereby allows 11,000 favored individuals and couples to retain $184,000,000 a year after taxes and after their $25,000 or $50,000 exemptions.

(4) The House bill fails to adopt the Treasury proposals for eliminating glaring loopholes and special privileges. It rejects Secretary Morgenthau's position that these loopholes are "Bad enough in time of peace" but they are "intolerable in time of war."

(5) The House bill fails to adopt the comparatively mild increases in estate- and gift-tax rates recommended by the Treasury. It thus allows inheritances and gifts to remain taxable at pre-Pearl Harbor rates.

CONGRESS FOR INDUSTRIAL ORGANIZATIONS' TAXATION FOR VICTORY PROGRAM

On June 3, 1942, the Congress for Industrial Organizations executive board adopted a resolution calling for a Federal tax program based upon ability to pay, to collect at least $10,000,000,000 additional revenue, from the following sources:

(1) $3,500,000,000 from corporate taxes by raising corporate income-tax rates to 50 percent, excess-profits rates to 94 percent, and by reducing excess-profits-tax credits.

(2) $4,500,000,000 from increased income-tax rates, especially in the middle and higher brackets, and based on 1941 exemptions, with a 25,000 ceiling on incomes after taxes, the plugging of loopholes, and the elimination of tax exemptions as recommended by the Treasury, by the adoption of mandatory joint returns, the taxation of income from State and local securities, and the elimination of unreasonable depletion allowances.

(3) The balance of the increased revenues from higher estate and gift taxes and from excises on selected loopholes.

The House bill falls far short of the Treasury's proposals, the Congress for Industrial Organizations' proposals, and the fundamental standards which should govern American wartime taxation, as follows:

INDIVIDUAL INCOME TAXES

In his appearance before the House Ways and Means Committee, the Secretary of the Treasury recommended additional individual income taxes designed to raise approximately $2,250,000,000 in new taxes. Surtax rates would be sharply increased and existing exemptions of $750 for single persons and $1,500 for married persons and family heads would be retained. The Secretary opposed a further lowering of personal exemptions, taking the position that it would be improper to tax single persons with incomes of less than $15 a week and married persons with incomes of less than $30 a week, who "already pay a disproportionate part of their little income in indirect taxes of all kinds." Subsequently, Secretary Morgenthau modified this position and proposed that personal income tax exemptions be reduced to $1,000 for married persons and heads of families and to $600 for single persons, and that the credit for dependents be reduced from $400 to $300.

The committee rejected the Treasury's schedule of proposed rates, substituted a schedule which hits the lowest income groups harder than the upper brackets (in comparison to the Treasury proposals), and lowered personal exemptions to $1,200 for married persons and family heads and to $500 for single persons. Under the committee's bill, adopted by the House, a single person earning more than $10 a week would be subject to income tax. A married man with no children would be subject to income tax if he earns $24 a week, and a married man with two children would be subject to income tax at $40 a week.

In comparison with the Treasury's original proposals, the House increases the tax paid by all married persons with incomes up to approximately $4,000 a year, but decreases the taxes payable by married persons with incomes in excess of approximately $4,000. For example, the Treasury originally proposed that a married man with two children who earns $2,400 pay an increased tax of $10. The House increased such a taxpayer's levy by an additional $40, while at the same time cutting $17 off the Treasury proposal with respect to such a taxpayer with an income of $5,000 and $77 off the Treasury proposal for such a taxpayer with an income of $6,000.

The following table shows strikingly how the House (by comparison with the Treasury's original proposals) lightened the burden of the higher income groups at the expense of the lower income groups.

Increases and decreases in tax resulting from the House changes in the Treasury's original proposals

Net income before personal exemption	Married, without dependents	Married, 2 dependents	Net income before personal exemption	Married, without dependents	Married, 2 dependents
$1,300	+$13		$10,000	−$283	−$283
$1,400	+30		$15,000	−483	−551
$1,500	+48		$20,000	−608	−593
$2,000	+60	+$13	$25,000	−710	−616
$2,500	+55	+18	$50,000	−1,817	−1,761
$3,000	+39	+51	$100,000	−1,905	−1,885
$4,000	−3	+23	$500,000	−14,935	−14,910
$5,000	−39	−17	$1,000,000	−21,935	−21,910
$6,000	−108	−77	$5,000,000	−104,935	−104,910
$8,000	−203	−189			

Such legislation is not designed to maintain the high morale of the American people, which is imperative to a victorious conclusion of the war. The low income taxpayer has already borne a large part of the financial sacrifice for war. Two million new taxpayers were added to the tax rolls through the lowering of personal exemptions by the Defense Tax Act of 1940, from $2,500 to $2,000 for married persons and family heads and from $1,000 to $800 for single persons. An additional two and one-fourth million taxpayers were subject to income tax through last year's revenue act, when personal exemptions were further lowered to $1,500 and $750. In addition, the large increases in sales and consumer taxes, effected by the tax laws since the beginning of the defense program, and the sharp increase in surtax rates in the lowest brackets have required substantial sacrifices of the average American.

As a result, the tax load borne by low-income groups in this country is far heavier than is commonly realized. Treasury studies have shown that a single person earning $750 a year not subject to Federal income tax, paid direct and indirect Federal, State, and local taxes of $130. This constituted 17.3 percent of his income and represented 8 weeks' pay. A married man, with no dependents, earning $1,500 a year, paid $250 in taxes, 16.7 percent of his income, and the equivalent of 8 weeks' work.

With the cost of living rising, the approximately 11½ million families with incomes under $1,500 are already engaged in a struggle to maintain the barest essentials of life. To lower personal income-tax exemptions below existing levels of $1,500 and $750 constitutes a threat to the health and well-being of more than a third of the American families. And at the same time to lighten the Treasury's originally proposed taxes on middle- and high-income groups at the expense of the lowest-income groups is to do violence to the principle of equality of sacrifice.

WAR TAXATION AND INFLATION

The House action in imposing a disproportionate burden of taxes on low-income groups cannot be justified as a measure required in the drive to stave off inflation. The estimated $17,000,000,000 inflationary gap between the goods and services available for civilian consumption during 1942 and the amount consumers will attempt to spend is a matter of greatest concern to all the American people and taxes have an important role to play in closing the gap. The gap must be closed by curtailing the incomes which threaten inflation and by dealing with the goods and services in which shortages exist, without at the same time jeopardizing the war effort by impairing the physical well-being or morale of the American people.

In resorting to the taxing power to curb inflation, we must not impair the stamina or morale of the soldiers of production, through excessive taxation of low-income groups. To do so would be to menace the entire home battlefront where the weapons of warfare are being produced. In addition, we must recognize that taxation is but one of a whole portfolio of instrumentalities available in the struggle against inflation. Taxation must be but one unit in an integrated program which utilizes price control, rationing, the purchase of war bonds and stamps, credit control, increase of production, effective use and conversion of productive capacity, raw materials, and manpower, etc.

The purchasing power which is responsible for the main inflationary pressures in the market place is not to be found in the pay envelope of the more than half of the American families with incomes under $2,000. It is to be found in the incomes of the middle and high bracket groups. However, to the extent that shortages and bottlenecks exist with respect to goods and services purchased by low-income groups, there are available effective instruments for dealing with the problem, without heavier taxation of low-income groups.

Rationing is the democratic method of dealing with consumers' shortages. Taxation of low-income groups is a crude and undemocratic method of attacking the problem. To cut down generally and willy-nilly the purchasing power of low-income groups because there are shortages in some consumers' goods is a form of social cruelty which cannot be tolerated. This would be a form of rationing of all consumers' goods in which a well-filled pocketbook would be the ration card. People with comfortable and large incomes would still be able to buy whatever is in the shops, despite rationing through taxation, but the low-income groups would have to cut down on their needs. Such policies do not fit in with the pattern of democracy.

The action of the committee, therefore, approved by the House under gag rule, in rejecting the Treasury's tax proposals so as to favor middle and high-income groups at the expense of the lowest income groups cannot be justified under the guise of the necessities of the fight against inflation.

TWENTY-FIVE THOUSAND DOLLAR CEILING ON INCOMES

In the first plank of his seven-point program to combat inflation, President Roosevelt urged that "we must tax heavily, and in that process keep personal and corporate profits at a reasonable rate, the word 'reasonable' being defined at a low level." As a specific measure to carry out plank No. 1, the President proposed the following:

"At the same time, while the number of individual Americans affected is small, discrepancies between low personal incomes and very high personal incomes should be lessened; and I therefore believe that in time of this grave national danger, when all excess incomes should go to win the war, no American citizen ought to have a net income, after he has paid his taxes, of more than $25,000 a year."

The Treasury subsequently submitted this proposal to limit incomes to $25,000 to the Ways and Means Committee, but it was rejected by the committee and the House. It was estimated that this tax would raise $184,000,000.

Every man, woman, and child in the Nation is being called upon to contribute his mite to the struggle against aggression. There are 11,000 single persons and married couples in this country who will have incomes in excess of $25,000 and $50,000, respectively, after paying the Federal taxes recommended by the committee, and after the 15-percent allowance for debts, insurance, Federal securities, etc. These 11,000 individuals and couples will thus have $184,000,000

in annual incomes to spend or save, after their $25,000 and $50,000 exemptions. Contrast these figures with the 17½ million families with incomes under $2,000, or the 75 percent of the American families with incomes under $3,000, both before taxes.

How can we make any pretense of applying the principle that the war tax burden should be distributed equitably in accordance with ability to pay without enacting the $25,000 ceiling? What is to happen to the morale of the millions of single people with incomes of $16 a week and married persons with incomes of $31 a week who are asked to pay income taxes at a rate of 19 percent, if the 11,000 favored persons and couples are allowed to retain an average of $320 a week after taxes and after their exemptions of $480 to $660 a week? How can we ask John Smith to spend 10 percent of his income for defense bonds or stamps, or to agree to stabilize his wages, while the 11,000 at the top of the American economic scale retain their excess $184,000,000 a year?

The unity of the Nation, the effectiveness of the President's seven point anti-inflation program and every principle of democratic sacrifice to win the war require the adoption of the $25,000 ceiling.

LOOPHOLES AND SPECIAL PRIVILEGES

The Treasury proposed the elimination of a series of loopholes and special privileges which enable small groups of taxpayers to escape their just share of the tax burden. All these proposals were rejected by the Ways and Means Committee, and of course, by the House.

(1) Mandatory joint-return laws allow a husband and wife to file separate tax returns, despite the fact that the ability of a husband and wife living together to pay taxes is measured by their joint incomes. This special privilege of filing separate returns is of advantage only to taxpayers with family incomes above $2,000 (under the Treasury's proposed rates) and the larger the income, the greater the benefit from the opportunity to file separate returns. In addition, in nine community property States, one-half the husband's earnings are automatically treated under the tax laws as belonging to the wife, with the result that there is a discrimination in the tax laws in favor of the taxpayers in the community property State. Thus, a married man, without dependents, living in the noncommunity property States of Colorado or New York and earning $5,000 per year, under the rate schedules proposed by the Treasury, would pay $115 more than the same man living in the community property States of California or Louisiana.

The privilege of filing separate returns has also resulted in tax avoidance through transfers by wealthy persons of securities or other property to their wives. As a result, the income is divided between the man and wife, and separate returns are filed in the payment of lower income taxes.

There is no justification for the continuation of the special privilege of filing separate returns if we are to make any pretense of taxing according to ability to pay. The Treasury's plan provides for a special allowance for earned income. The adoption of this proposal would result in additional revenues, under the Treasury's rate schedule, of $440,000,000.

(2) *Income from State and local securities.*—The Ways and Means Committee rejected the Treasury's recommendation that the interest from all outstanding and future issues of State and municipal securities should be subject to tax, which would produce an estimated yield of $275,000,000. High tax rates are utterly meaningless to the holders of tax exempt securities. As stated by Secretary Morgenthau:

"A tax system cannot be defended which in a time of grave national emergency calls upon the great mass of our taxpayers to shoulder the heavy burden of additional taxes and yet permits persons with large taxpaying ability to pay virtually nothing in taxes. The sacrifices necessary to win a war for the benefit of all of us should be shared by all of us—including the holders of tax exempt securities."

The continuation of the tax exemption of the interest from State and municipal securities is a haven for the wealthy taxpayer which is "bad enough in time of peace" and "intolerable in time of war." Tax exempts should be made taxable.

(3) *Percentage depletion.*—The privilege granted to owners of mines and oil wells to deduct percentage depletion long after they have recovered the cost of the property is a "special favoritism," whose abolition the Treasury recommended. Although the termination of this special privilege would bring an additional estimated $206,000,000 into the Treasury, the proposal was blocked by the Ways and Means Committee.

There is no warrant for allowing a taxpayer to obtain depletion deductions in excess of the cost of the property. The demands of the war make it imperative that this privilege be eliminated.

CORPORATION TAXES

The only feature of the committee's bill adopted by the House which even begins to measure up to sound wartime standards of taxation is its proposal that corporate income taxes be levied at 45 percent and excess-profits taxes at 87½ percent. The committee rejected the Treasury proposal that corporate income and surtax rates should be increased to a total of 55 percent (for corporations with incomes in excess of $25,000), and instead adopted a combined rate of 45 percent. It whittled down its own original plan to increase the excess-profits rate to 94 percent, finally proposing a rate of 87½ percent. As a result, the committee proposals for corporate taxes will yield only $2,420,000,000 by way of contrast with the Treasury's recommendations for $2,796,000,000 in increased corporate levies, a loss of approximately $375,000,000.

No basic change has been made in the provisions of the excess-profits tax law other than to reduce from 7 percent to 6 percent and 5 percent the invested capital credit on investments in excess of $10,000,000. Corporations are still permitted to elect either the invested-capital method or the average-earnings method of computing excess-profits taxes. The result is that corporations which are heavily overcapitalized or showed large earnings during the period 1936-39 are still in a position largely to escape their fair share of excess-profits taxes. The excess profits tax law still treats 50 percent of borrowed capital as invested capital. High rates are utterly meaningless to corporations with high excess-profits credits. These basic defects in the excess-profits tax law were responsible for the statement by the Assistant Secretary of the Treasury, John L. Sullivan, to the Ways and Means Committee in connection with the revenue revision of 1941 that "we now have on the statute books a tax which is called an excess-profits tax, and which the country believes is an excess-profits tax. The truth of the matter is that the law we call an excess-profits tax *does not tax excess profits at all.*" [Our emphasis.] These defects remain unremedied in the committee's bill adopted by the House.

The House's solicitude for corporations cannot be squared with the demands made upon the American people generally. While the average American has watched his tax bill soar, he has been called upon to make greater sacrifices. The workers have given up their right to strike for the duration. The President in his seven-point message to Congress dealing with inflation, on April 27, 1942, called for wage stabilization and for heavy taxation. Organized labor has responded splendidly and patriotically with all-out support for the wage-stabilization program. As to taxation, the President said:

"To keep the cost of living from spiraling upward we must tax heavily, and in that process keep personal and corporate profits at a reasonable rate, the word 'reasonable' being defined at a low level."

Corporations and their stockholders will not want to shirk their duty in fighting the war and in safeguarding the economy. The Treasury's proposal for a 55-percent combined normal and surtax rate for corporations with net incomes in excess of $25,000 is designed to help carry out the tax plank in the President's program and to allow the taxes paid by corporations with the sacrifices required of the average citizen. Inasmuch as corporations are expected to retain billions in profits after paying the taxes proposed by the Treasury, these rates are not unreasonable in the light of the standars of sacrifice dictated by the events since Pearl Harbor. As the President stated in his Budget message on January 7, 1942:

"When so many Americans are contributing all their energies and men their lives to the Nation's great task I am confident that all Americans will be proud to contribute their utmost in taxes."

Equality of sacrifice is essential to the maintenance of the morale of the American people at its present high level. If the average citizen is called upon to make heavy sacrifices, while corporations and their stockholders either profit from our great national crisis or make no commensurate sacrifices, the entire war effort, our national unity, and the morale of the people will be in jeopardy.

ESTATE AND GIFT TAXES

The Treasury suggested comparatively mild increases in estate and gift taxes and modifications in exemptions, which together would yield $309,000,000 in new revenues. The committee modified the exemptions, which would reduce estate and gift taxes by approximately $7,000,000, but rejected rate increases.

Under the bill as proposed by the Ways and Means Committee, an estate of $60,000 would pay no tax. The Treasury proposed that an estate of $100,000 pay $7,450, instead of the present tax of $7,400; that an estate of $2 0,000 pay $16,950 instead of the present tax of $35,700; that an estate of $1,000,000 pay $512,550 instead of the present tax of $307,200. These illustrations indicate the comparatively mild character, as measured by wartime standards, of the proposed estate tax rates. Comparable increases of gift tax rates were urged.

It is a sad commentary on the committee's work that personal exemptions should be lowered to $1,200 and $500 while a $60,000 estate goes tax free and estate and gift tax rates remain at pre-Pearl Harbor levels. The President did not exclude estates in excess of $60,000 when he urged every American to contribute his mite in the fight against aggression. What is needed is the adoption of an integrated estate and gift tax system with lowered exemptions and with a single set of drastically increased rates.

SALES TAX

The reactionary drive for a Federal sales tax. The committee's proposal and the House's adoption of a tax bill falling $2,500,000,000 short of the Treasury's request and $4,000,000,000 short of the Congress of Industrial Organizations' program of taxation for victory foreshadows a new tax bill during the current year. It lays the foundation for a renewed drive on the part of the advocates of the soak-the-poor-save-the-rich policy for a Federal sales tax. The National Association of Manufacturers, the United States Chamber of Commerce, and the spokesmen and satellites were defeated in their campaign before the Ways and Means Committee in their attempt to foist a Federal sales tax upon the American people. The drive is on again. The Secretary of the Treasury has forcefully presented to the Nation the vital reasons for opposition to a general sales tax.

1. "The general sales tax falls on scarce and plentiful commodities alike.

2. "It strikes necessaries and luxuries alike.

3. "As compared with the taxes proposed in this program it bears disproportionately on the low-income groups whose incomes are almost wholly spent on consumer goods. It is, therefore, regressive and encroaches harmfully upon the standard of living.

4. "It increases prices and makes price control more difficult. It stimulates demands for higher wages and adds to the parity prices of agricultural products.

5. "It is not, as many suppose, easily collected; on the contrary, its collection would require much additional administrative machinery at a time when manpower is limited."

Wage earners, salaried employees, and others in the low-income groups already face a hard struggle for existence because of rising prices and the increased living costs. A general sales tax would cut many meager incomes below subsistence requirements.

Labor has given all-out support to the President's anti-inflation program. It has agreed to wage stabilization; it has purchased millions of dollars of War Bonds; it has supported all-out rationing and price control. Labor will not sit by idly and see the President's tax plank in the anti-inflation program scuttled by a Federal sales tax. Such an unfair, inequitable, and regressive tax would foster national disunity and seriously hamper the war effort. The soldiers on the production front cannot produce guns, tanks, and airplanes without calories.

CONCLUSION

Taxation as usual can be as devastating to the war effort as business as usual. Labor vigorously opposes both. The Congress of Industrial Organizations agrees

with Secretary Morgenthau that the task "of enacting the 1942 Revenue Act is that of making the tax program an instrument of victory."

The Ways and Means Committee's bill, adopted by the House, fails the American people in their time of great need. The Treasury's original proposals, coupled with the $25,000 ceiling on incomes, is the very minimum required for a democratic war tax program. We urge the adoption of the Congress of Industrial Organization's tax program in order to forge out of the tax bill a powerful instrument for victory.

The CHAIRMAN. Mr. Robinson.

STATEMENT OF REID ROBINSON, PRESIDENT, INTERNATIONAL UNION OF MINE, MILL, AND SMELTER WORKERS, C. I. O.

Mr. ROBINSON. Mr. Chairman, I am appearing before this committee in behalf of the International Union of Mine, Mill, and Smelter Workers, as vice president of the C. I. O., and as a member of their national C. I. O. tax committee.

As has been pointed out in President Murray's statement, presented to your committee by Mr. Cowan, the 1942 tax bill is the most important tax bill that has ever been before Congress.

Our country is at war, facing the most desperate crisis that we have ever faced.

The test of strength between democracy and fascism is before us. The armies of Hitler are advancing. The valiant Red Army of the Soviet Union, which has held off the Hitler advance for more than a year, is in retreat before numerically superior Nazi forces. Our British allies are fighting desperately to stop the Axis advance through Libya and Egypt.

The United States and Great Britain face the gigantic military task of opening a second front against Hitler.

Our Commander in Chief, President Roosevelt, has joined with Churchill and Molotov in agreement that this second front will be opened in 1942. The people of our country, Britain, and the Soviet Union are united in endorsing this action—because they realize that victory can come only if the second front is opened without further delay.

Our second front must be backed up by an economic front at home, dedicated to the offensive and to victory. President Roosevelt's seven-point program must be carried out to make this home economic front secure.

In this program the President called for an adequate and fair tax bill. He said:

> To keep the cost of living from spiraling upward we must tax heavily, and in that process keep personal and corporate profits at a reasonable rate, the word "reasonable" being defined at a low level.

This is the tax program of President Roosevelt. It is the tax program that the United States Treasury Department urged on Congress. It is the tax program that the 5,000,000 workers of the C. I. O. have been demanding from their elected representatives. It is the tax program that the American people demand for victory. Such a tax program must be based on the following principles:

1. We must raise at least the 8½ billion dollars that the Treasury set forth as the minimum in added tax revenue required to carry out the war program.

2. This added revenue must be raised on the basis of ability to pay.
3. There must be a limit of $25,000 on net personal income.
4. Loopholes used by wealthy individuals and corporations to evade their patriotic duty to the Nation must be eliminated.
5. We must reject any proposal to raise revenue through sales taxes of any kind.

The House of Representatives has passed a tax bill. This bill, reported out by the House Ways and Means Committee and passed under a gag rule, does not measure up to the standards of an adequate and democratic war-tax bill.

The House bill falls short by close to 2½ billion dollars of the 8½ billion asked by the United States Treasury. The task before this committee is to report out a tax bill that will meet the financial requirements of our war program—and which, at the same time, will strengthen our economic front at home.

The additional 2½ billion dollars—left out of the House bill—must be raised by applying the principles set forth by the Treasury and listed above. To do this, we must first raise 4½ billion dollars from increased income taxes, levied on individuals in the middle and higher income brackets.

The bill passed by the House failed to meet this need.

In comparison with the Treasury's original proposals, the House increases the tax paid by all married persons with incomes up to approximately $4,000 a year, but decreases the taxes payable by married persons with incomes in excess of approximately $4,000.

For example, the Treasury originally proposed that a married man with two children who earns $2,400 pay an increased tax of $10. The House increased such a taxpayer's levy by an additional $16, while at the same time cutting $17 off the Treasury proposal with respect to such a taxpayer with an income of $5,000 and $77 off the Treasury proposal for such a taxpayer with an income of $6,000.

I am submitting a table, as an exhibit, which shows strikingly how the House lightened the burden of the higher-income groups at the expense of the lower-income groups—by comparison with the Treasury's original proposals.

In addition to the 4½ billion dollars to be raised from increased individual income taxes, this bill must raise 3½ billion dollars from corporate taxes—by raising corporate income tax rates to 50 percent, excess profits rates to 94 percent, and by reducing excess profits tax credits.

As the bill was passed by the House, the corporate income tax is 45 percent, and the excess-profits rate is 90 percent. As a result, corporate taxes will yield only $2,640,000,000 by way of contrast with the Treasury's recommendations for $2,796,000,000 in increased corporate levies—a loss of approximately $156,000,000.

President Roosevelt said in his seven-point message:

> No American citizen ought to have a net income after he has paid his taxes, of more than $25,000 a year.

We agree wholeheartedly with President Roosevelt that such an income is ample to live upon. The average income of 17⅓ million American families was under $2,000 in 1941. Seventy-five percent

of all American families had an annual income of less than $3,000 a year, before taxes were paid.

Some 11,000 families today enjoy an income above the $25,000 level. At the same time, we are proposing to tax a married worker with an income of $24 a week. To tax such families while permitting the very rich to keep incomes of $1,000 a week and over is a serious blow to national unity and morale.

Furthermore, this refusal to limit individual incomes to the comfortable figure of $25,000 a year will cost our war effort $184,000,000 a year in needed revenue.

One of the gravest defects in the House tax bill is the failure to stop up a series of loopholes which permit wealthy individuals to evade their patriotic duty to their country.

These loopholes include the failure to abolish the scandal of tax-exempt securities and the failure to abolish the scandal of separate returns. These exemptions cost the Nation hundreds of millions of dollars a year. They are available only to the rich. They should be abolished at once, not only to raise needed tax revenue but to build national unity and national morale for victory.

The tax bill as passed by the House falls short by two and one-half billion dollars of the amount of needed tax revenue called for by the United States Treasury and the C. I. O. This leaves open an avenue of approach that the antilabor, antivictory forces have been looking for—the avenue of approach to a sales tax. The opposition of the C. I. O. and labor and progressive forces to the sales tax has been stated many times.

To begin with, the sales tax is the most unfair and undemocratic method of taxation yet devised. It takes the same amount of money out of everyone, regardless of ability to pay. A worker with an income of $30 a week pays the same tax on his food and other family needs as a coupon clipper with $50,000 a year.

The man with the big income doesn't feel it. He doesn't eat very much more food than the $30-a-week worker. He can't wear very much more clothing. He's glad to pay a sales tax—particularly if it helps him escape stiff taxes on his income.

Takes a sales tax out of the worker's pocket and you are taking groceries out of his budget, actually taking food and other necessities out of his home. Ten percent or any percentage taken out in sales taxes means much less food and clothing and shelter.

Mr. Chairman, we present this program for a 1942 tax bill in the knowledge that our victory over Hitler's Axis will cost huge and hitherto unbelievable amounts of money.

We endorse the seven-point program of President Roosevelt for an offensive against Hitler, because we know that this is the only way to victory.

We are ready to pay the price of this offensive, because we realize that victory will come only through the opening of a second front against Hitler in Europe.

Your committee faces the grave responsibility of reporting out a tax bill that will strengthen our home front and support our Commander in Chief, President Roosevelt, in carrying out the final offensive against the Fascist Axis.

(The table referred to by Mr. Robinson is as follows:)

Increases and decreases in tax resulting from the House changes in the Treasury's original proposals

Net income before personal exemption	Married, without dependents	Married, two dependents	Net income before personal exemption	Married, without dependents	Married, two dependents
$1,300	+$13		$10,000	−$283	−$263
$1,400	+30		$15,000	−483	−451
$1,500	+48		$20,000	−608	−593
$2,000	+49	+$13	$25,000	−740	−618
$2,500	+55	+48	$50,000	−1,817	−1,761
$3,000	+39	+54	$100,000	−4,305	−4,305
$4,000	−3	+23	$500,000	−14,935	−14,919
$5,000	−39	−17	$1,000,000	−24,935	−24,919
$6,000	−108	−77	$5,000,000	−104,935	−104,919
$8,000	−203	−180			

The CHAIRMAN. Thank you, Mr. Robinson.

Mr. McDonald.

Mr. APPELBE. Mr. Chairman, Mr. McDonald was held up in the Little Steel negotiations in New York.

The CHAIRMAN. Mr. McDonald will not be here?

Mr. APPELBE. He will not be here. I have his paper here.

The CHAIRMAN. You have a statement for him?

Mr. APPELBE. I do.

The CHAIRMAN. Very well, you may read it.

STATEMENT OF CLARK APPELBE, ASSISTANT TO SECRETARY-TREASURER, UNITED STEELWORKERS OF AMERICA, CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. APPELBE. Mr. Chairman and members of the committee: I want to state that I am appearing here this morning on behalf of Mr. McDonald, secretary-treasurer, United Steelworkers of America. He originally intended to appear but was unable to leave New York due to the "Little Steel" negotiations. Mr. McDonald's statement is as follows:

Yesterday the United Steelworkers of America, of which Philip Murray is president and of which I am secretary-treasurer, started a series of negotiations which, in the next 2 weeks will involve the 5 corporate organizations responsible for the production of more than 90 percent of this Nation's basic steel output. I have taken time out from these negotiations to prepare this statement for this committee, because the 600,000 steel workers of the organization which I represent recognize the vital significance of these hearings, not merely to themselves but to the Nation.

I wish only to lay before you certain hard, cold facts, facts within my own knowledge which should be of assistance to you in making your decisions. My remarks deal primarily with the steel workers of this country because these are the men whom I know personally, whose problems I have shared since the inception of their organization, whose lives and work I can describe to you from first-hand contact.

The history of the steelworkers of America ever since the inception of the present threat to our national existence has been one of constant and unstinting sacrifice and devotion to the cause of our Nation. The men working in our steel mills are drawn from a multitude of different national and racial sources. There is a large proportion of immigrants from many countries. There is a large proportion of first-generation Americans of many stocks.

Nevertheless, all these merged in one labor organization have been without exception also merged in one common effort to produce the maximum quantity of steel for victory over the Axis.

I do not know how many of the members of this committee have any personal familiarity with the nature of the work in the mills and with the lives of the men who do that work. It is grueling work. It is, in many instances, nasty work.

In many instances it is extremely dangerous work, as scared bodies and twisted limbs among the members of our organization will easily attest. It is work at which over the years men have been forced to bring up their families, undernourished, living in the shadow of the mills and slag heaps.

For several decades the men in these mills have struggled to achieve organization so that they might improve their working conditions and achieve a better standard of living for themselves and their wives and children. That dream was finally realized by the steelworkers in the last few years when they succeeded in organizing for the first time a stable and strong organization in a position to act for the workers in an overwhelming percentage of the entire industry.

Nevertheless, when in 1941 American labor undertook to forego for the duration any exercise of the strike weapon and to prevent any interference with continued production, the steelworkers' organization with its many racial groups, with its background of struggle, was nevertheless among the first to respond patriotically to the call to place its faith in the hands of the agency which the President then established. In taking their action these men of the mills were buoyed up by the realization that this was a war for freedom and for the maintenance of free institutions. They acted with the full faith and understanding that this was not a war in which any section of the population was to be permitted to secure special benefits, that this was not to be a war in which new millionaires were to be created, or in which existing millionaires were to be permitted to profiteer.

It was this reason that the steelworkers hailed the announcement of the President's seven-point program against inflation. They hailed a program which committed this Nation to the basic democratic principle of equality of sacrifice for victory.

Recently the steelworkers brought to the attention of the War Labor Board the fact that during the past year the cost of living had risen so sharply that a continuation of their current wages constituted a drastic threat to their health and welfare. The War Labor Board told the steelworkers that despite threats to health and welfare, they would have to return to living standards which would deprive them of benefits which they have achieved from their organization not merely this year, but last year. They were, in effect, asked to accept a substantial cut in their real wage levels. The War Labor Board

granted adjustments only to what amounted to preorganizational levels.

The steelworkers have already accepted that determination. They accepted it in the interests of continued and consistent production for victory. The principles of the decision affecting them may now be expected to apply to thousands of American workers.

It is important to note that in determining that principle the War Labor Board relied exclusively on the data relating to the cost of living as of recent months. In arriving at its decision the War Labor Board expressly assumed that the President's program would be effective to control the cost of living. The War Labor Board expressly decided to fix the income of the steelworkers with relation to that assumed cost of living. In accepting the War Labor Board decision the steelworkers carefully considered the entire national picture. They declared, and I am now simply conveying to this committee the words of the representatives of the steelworkers, that:

> The workers now look toward the President and Congress to carry through the remaining portions of the national economic program, such as an effective tax program and a real effective freezing of prices of food, rents, and other items of cost to the people.
>
> We shall watch this phase of the program most carefully. The workers are entitled to know whether their living costs are going to be stabilized, upon which principle the present award of the Board in the Little Steel case has been predicated.

In the tax bill now before this committee, the Treasury Department asked for some 2.5 billion more than the House has granted.

The House has cut out additional revenues which would be derived from acceptance of the corporate-tax levels and the income-tax levels which the Treasury urged, and has refused to eliminate certain loopholes in the present tax structure. Other speakers have addressed themselves and will no doubt address themselves to these features of the bill.

One of the most insidious features of the situation, however, is the suggestion that has been made at various times, that instead of raising the additional needed revenue in accordance with the manner proposed by the Treasury experts, the additional money be raised through a sales tax.

I say to you that anybody who attempts to impose at this time upon this Nation a Federal sales tax would be trifling with the national war effort and would be placing a keg of dynamite under the structure of our national morale.

The steelworkers, as I have pointed out, are engaged in an industry which perhaps more than any other is at the heart of our war-production machinery. They are giving of their sweat, blood, and tears not merely through their sons and brothers sent to the Army but in their daily gruelling work. It is work which cannot be carried on in impaired health or with inadequate nutrition.

Their standards have already been impaired but they have accepted the impairment as a necessity of the war effort. The extent of that impairment has been carefully gaged in the light of expanding living costs. A failure by this committee to adopt a program to raise the needed funds in accordance with the principles of the Treasury's proposals will on the one hand constitute an arrogant slap at the faith of

the workers in the Government's intention to carry through the President's seven-point program. More significant, the adoption of a sales tax would cut deeply into family budgets already slashed far below the danger point.

When I say these things to this committee I am not here simply to state my own views. The simple fact is that the 600,000 steel workers organized in the body which I am privileged to represent are fully aware of the issues placed before this committee. Those issues have been the subject of discussion throughout our membership, just as they have been the subject of comment and discussion throughout the organized labor movement. The problem before this committee is not merely one of dollars and cents. It is one of national faith and confidence. It is one of family budgets and workers' health.

As a problem of workers' health, it is a problem of national war production. An attempt to impose a sales tax will be a vital blow at national war production. An effective tax program which imposes equality of sacrifice with an eye to ability to pay will constitute a long step in the direction of military victory.

Thank you.

The CHAIRMAN. Thank you, Mr. Appelbe.

Mr. Haddock.

STATEMENT OF HOYT S. HADDOCK, REPRESENTING THE CONGRESS OF INDUSTRIAL ORGANIZATIONS MARITIME COMMITTEE

Mr. HADDOCK. The present tax bill, as proposed by the House, falls far short of the requirements of an adequate program in line with the President's seven-point program. As the present bill is constituted it is an open road for inflation and profiteering and negates all possibility of the complete realization of the President's program.

The Congress of Industrial Organizations unions are in the thick of the fight delivering the goods, and "keeping 'em sailing" though hundreds of seamen have lost their lives in so doing.

However, it is their feeling that their sacrifices must also be met with the cooperation and assistance of those at home. They are opposed to those who desire first of all to guarantee their profits and then to win the war. The C. I. O. maritime unions believe, as pointed out by Secretary of the Treasury Morgenthau, that taxation should combat inflation and contribute to national unity at a time when the country is in greater danger than ever before.

We believe that the bill passed by the House is inadequate to meet war needs. The special privilege features of the bill places the heaviest burden upon those least able to bear it. Since the bill does not provide a sufficient amount of money, it has left the way open for the proposal of a sales tax, to which we are unalterably opposed.

We should like to propose that the bill under consideration be strengthened to combat inflation by incorporating to the fullest extent the items of the President's seven-point program.

Securities which are at present tax-exempt should be taxable. We oppose the further lowering of the income tax-exemptions, which would increase the tax load upon the lower paid workers out of all proportion to that placed upon the higher income groups. Joint

income tax returns from husbands and wives should be made mandatory. The $25,000 ceiling on incomes, as proposed by the President, should be incorporated in the bill, as should the Treasury proposal for corporation taxes.

The C. I. O. maritime unions are in support of the C. I. O. tax proposals and urge this committee to adopt such proposals in order to further our war effort and provide a stable war economy in our Nation.

Thank you.

The CHAIRMAN. Thank you very much for your appearance.

Mr. Nixon.

STATEMENT OF RUSS NIXON, REPRESENTING THE UNITED ELECTRICAL, RADIO, AND MACHINE WORKERS OF AMERICA, CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. NIXON. At the outset, I must indicate that I am appearing before you not as a tax expert, but rather to indicate the views of approximately 425,000 war workers in the electrical, radio and machine industry who also are not tax experts but who do have a vital interest in the tax bill. These workers, organized into the United Electrical, Radio and Machine Workers of the C. I. O., include the employees of such outstanding war production organizations as the General Electric Co., the Westinghouse Electric Co., the Electrical Divisions of the General Motors Corporation, R. C. A., Philco, Colt Fire Arms, and more than 800 other companies and plants. I am presenting this statement under the mandate of these workers which arises from action on the tax issue taken at our last annual convention, from the action taken by the general executive board of the international union and by resolutions adopted throughout the country in hundreds of U. E. local and district membership meetings.

The workers I represent are engaged in the manufacture of ship propulsion machinery, machine guns, propellers, shells, military radio equipment, bomb sights, bombs, antiaircraft guns, and so forth. They are expanding every energy to increase the production of these war items. Approximately 30,000 of our membership have laid down their tools and taken their place in the armed forces of the country. Better than 90 percent of the more than 200,000 U. E. workers in General Electric, Westinghouse, and General Motors are voluntarily checking off 10 percent of their weekly pay for the purchase of war bonds. This is true of practically our entire membership. The U. E. leads the country in the effective development of joint labor-management production councils, having had more than 50 of these councils in operation prior to Donald Nelson's request for their organization throughout the land. There has been virtually 100 percent compliance with the pledge of uninterrupted war production on the part of all these workers since Pearl Harbor. All the energies, thoughts, and efforts of this union are directed to the successful prosecution of an all-out war effort to defeat the Fascist enemies of the American people.

This is the background with which the U. E. approaches the problems of the 1942 revenue bill. The interest of these workers in the

tax issue is simply: How can we make the 1942 tax bill the strongest instrument for victory?

The tax bill must take its place as point No. 1 in the President's seven-point program—the national war economic policy. In this program, which is vital to the war effort, it is significant that the President placed as the first of the seven points the question of taxation. The President's conception of what is required of the tax bill is implied in his specific proposal that income tax schedules should be so increased that "no American citizen ought to have a net income after he had paid his taxes of more than $25,000 a year." An approach of similar degree is clearly indicated in the President's program insofar as corporation profits and tax loophole issues are concerned if the tax part of the President's seven-point program is to be carried out.

This union was the first large organization in the country to announce its unequivocal support of the President's seven-point program. We declared this support the day after the President's message to Congress. This union accepted the wage stabilization plank of the President's seven-point program. It urges complete price control and a thorough rationing program and is taking practical steps throughout the country to put these proposals into practice. The extensive practical cooperation of this union with the bond purchase program has already been indicated. Each of the points of the program has the active support of my union. We consider that as the President has said, this program is "indivisible"—that "each one of these points is dependent on the other if the whole program is to work."

Thus we feel that to play its proper, vital role in the President's seven-point program the provisions of the 1942 tax bill must keep step with the gigantic proportions of the world struggle in which we are engaged. I should like to indicate the views of the workers I represent on this question of how we can make the tax bill the strongest possible weapon for victory.

The first requirement is that the tax bill must raise a volume of revenue which is in proper proportion to the financial burden imposed by the war. Its adequacy must be measured in light of the fact that $77,000,000,000 will be spent for war purposes in the fiscal year covered by this bill. The increase in revenue raised by this measure must be evaluated with the knowledge that war expenditure in the ensuing fiscal year will increase $45,000,000,000, and that the proportion of the national income going to the war will increase from 14 percent in 1941 to 50 percent in 1943.

While the country plans increased expenditures of $45,000,000,000 the House Ways and Means Committee plans a tax bill that will increase the revenue by $6,300,000,000. For the year that we will spend $77,000,000,000, the House Ways and Means bill proposes to raise revenue approximating $24,000,000,000. The conclusion is inescapable that the increase in total revenue contemplated by the House Ways and Means bill is woefully inadequate. The Secretary of the Treasury has stated that the tax bill should increase revenue at least 2½ billion dollars more than is provided for by the House bill. We propose that the tax revenue should be increased at least $10,000,000,000,

giving a total revenue yield of at least $28,000,000,000 and increasing the revenue that would be raised by the House bill at least $4,000,000,000.

Failure to make such an increase in the tax bill will mean that our tax program is not in tune with our war program. It would create a weak link in the vital chain of all-out war economic policy.

Secondly, a tax bill that is truly an instrument for victory must be a most powerful weapon against inflation. The tax bill must be one of the principal means of diverting the swollen streams of income from exerting inflationary pressure upon dwindling consumer products which diminish in volume as 50 percent of our national income goes to the war. To do this job, taxation must be levied upon those categories of income receiving swollen war income.

Estimates of the Office of Price Administration have revealed that of the approximately $16,000,000,000 increase in consumer income in 1942, about $11,000,000,000 goes to families having—in the year—an income of between $2,500 and $10,000, while a $6,000,000,000 increase goes to families receiving $10,000 and over in 1942. According to these estimates, the income category of families receiving less than $2,500 in 1942 does not represent any of the $16,000,000,000 increase in consumer income, total income in this category actually being $1,000,000,000 less in 1942 than in 1941. The obvious conclusion to be drawn is that as an anti-inflationary measure the 1942 tax bill must place the principal burden upon family units receiving more than $2,500 a year.

Swollen incomes flow also into the coffers of American corporations. Great volumes of incomes, both corporate and private, escape the full effects of taxation through serious loopholes in the tax structure. If the tax bill is to play its full role in the President's program against inflation, the tax on incomes above $2,500 must be considerably increased above the provisions of the House bill, and the very serious loopholes ignored by the House measure must be closed by forthright action of the Senate.

A real victory tax measure must apportion the burdens of the war in such a way as to maintain to the fullest possible extent the full efficiency of America's working force engaged in the production of the weapons of war. In the interests of the war it is imperative that the full productive capacity of American workers not be reduced.

It should be clear that in making this point I am not referring to any question of equality of sacrifice. I am referring, rather, to the obvious fact that in a "war of production," the health and efficiency of war workers is a positive war asset.

It is conceivable that we might reach a national condition where it would be necessary to say to workers "The Nation cannot afford to give you enough to eat and an adequate place to live, even though this may hurt the war effort by reducing your output of guns, shells, bombs, etc." Obviously, such a circumstance could arise only as a last resort. In an all-out war effort, it would not come about unless there was an unavoidable over-all national shortage of the goods that make up a basic standard of living. More than that, in an all-out war effort such a disabling development would not be experienced by workers unless all other nonwar production citizens had already reduced their consumption.

To put it in another way, in an all-out war effort we would not say to a worker in a machine-gun factory, "You cannot have enough food to eat," unless we had already said to idle rich Mr. and Mrs. Gotrocks, "You must reduce your consumption of food to a level determined with reference to your contribution to the war effort."

I do not see how anyone supporting the all-out war effort can disagree with the above proposition. The tax program in conjunction with rationing and other points of the President's program must seek to distribute the burden of the war along the above lines.

The point just made implies some "minimum efficiency level" of income. While it is true that no one knows, to the last decimal for every community and every line of work, the exact figure for this level, sufficient data and sufficient practical experience is on the record to make possible a very good approximation. You may put it at $2,400 per year which is the so-called Heller committee budget for a workers' family of five, priced at January 1942 prices, or at about $2,000 per year which is the lowest and most conservative estimate we have been able to find by any nonunion authority, for a married couple with no children. Whatever basis you care to use, the level is going to be around $2,000–$2,200–$2,400 for the average family. For the single man without dependants, the same level runs perhaps $750 or perhaps a full $1,000 lower. It must be recognized that approximately 70 percent of the family units in the country will receive an income in 1942 that is below $2,500. It is well known by this committee that incomes below this level not only pay individual income taxes but also pay an unusually large proportion of their income in total direct and indirect taxes.

The above observations have obvious implications for a win-the-war tax program. They indicate first, that the tax levies, especially of the victory tax bill, must not fall upon worker families whose income is already scarcely adequate to maintain health and efficiency. Income taxes levied upon individuals receiving $500 a year or upon a man and wife whose income is $1,200, can have no other effect than to further depress already substandard living conditions. The very special impact of rising living costs and shortage of goods upon families in these low income levels must be recognized. For this reason the lowered exemptions provided for in the House bill should be abolished. Indeed, the logic of the situation calls for raising the exemptions above even the present provisions of the law.

The proper distribution of the war burden underscores the necessity of levying taxes according to the ability to pay. The imposition of the general sales tax violates this principle. The general sales tax would levy the tax burden in an inverse ratio to a person's wealth. Such tax completely ignores the necessity, in the interest of the war of maintaining the health efficiency—yes; even of increasing, in some cases, the health and efficiency of the American working force. It must be recognized, also, that there is no immediate revenue raising function to be played by the general sales tax which cannot be achieved by adjustment in individual income-tax rates. Today as never before, the productive capacity of the American workers is our greatest asset. The 1942 tax bill, if it would serve the war effort, must build, rather than undermine, this productive capacity.

If the 1942 tax bill is to be an instrument for victory in this war its provisions must be such as to establish the bona fides of a people's war. Our convictions that we are engaged in a people's war, that this is, in the words of the Vice President, "the century of the common man," are tested and find their true meaning in the actual results and deliberations such as yours on the tax bill, where actual decisions of policy are made. I refer not so much to the possible demoralizing effects of the failure to take proper action on the tax bill as to the positive opportunity presented to you to make a genuine contribution to the morale and enthusiasm of the people through a vigorous, enlightened progressive action on the issues of this measure.

In considering the 1942 tax bill the Congress must choose in a general way between a set of proposals supported by labor, consumer, and other progressive groups on the one hand and a set of proposals supported by great corporate and special interests, by the great agencies of big business such as the United States Chamber of Commerce and the National Association of Manufacturers. That you face such a general choice cannot be denied. The working people of the country recognize this great general issue involved in the tax deliberations. It must be clear to everyone that the choice you make is of utmost importance to the morale of the American common man in these days.

I am not here to request a sop for labor or to ask for a mere gesture which would stimulate morale. I would urge rather that this measure be approached with a full realization that the people of this country really believe this is a people's war and to them that means in terms of the tax bill that their elected representatives will not be swayed by the powerful lobbies of corporate interests but will move ahead to abolish the special privileges of the rich and make sure that individuals and corporations do not grow rich from the Nation's time of trouble and difficulty.

To the hundreds of thousands of war workers for whom I speak these are the methods by which the 1942 tax bill can be made an instrument for victory. Thus far I have not discussed detailed proposals. I have full confidence in the knowledge and ability of this distinguished committee to solve the complications and details of tax legislation required to meet provisions I have set forth. The experts in the United States Treasury, men who, with extensive research staffs, spend their full time studying tax legislation are available to you. Indeed, they have already proposed the specific means of substantially increasing the revenue of the bill and of correcting the intolerable loopholes contained in the Ways and Means Committee measure. I do not presume to be a substitute for their full and expert knowledge in this respect. I am sure that Mr. Randolph Paul could render upon request all the assistance necessary to formulate changes in the tax bill which would increase its revenue raising qualities $10,000,000,000 without adding a sales tax. Let me summarize, however, the specific lines upon which we base a proposition to revise the House bill.

1. Increases in individual income-tax rates, particularly at the range above $3,000 should be made. The House bill revised downward the levies proposed by the Treasury for incomes above $3,000. Not only should these rates be increased in the middle-income brackets even above the Treasury proposals, but in addition the income

tax rates should put into effect the President's proposal that no individual shall have an income after taxes, of greater than $25,000. In respect to this last point I would urge you to recognize that the workers of this country are particularly interested in this proposal. They all know about it, they all took it seriously. In a sense it is the touchstone of the common man's conception of the tax bill. It will be a most regrettable situation if this proposal of the President is utterly ignored by the Senate as it was by the House.

2. The definition of excess profits and the schedule of corporate taxes must be formulated so as to considerably increase the revenue from this source and so as to eliminate the high rate of return on invested capital employed in the production of war goods. The present definition of excess profits utterly fails to meet the requirement of eliminating war profiteering. It is entirely unjustifiable, even though the semimonopoly position of the General Motors Corporation may have allowed it to earn 20 percent on its investment in past years—that this corporation should be able to claim as normal profits $20 out of each $100 it receives from the Government for the manufacture of tanks, machine guns, propellers, and so forth. The base and surtax corporate rate should be increased to the original Treasury proposal of 55 percent, and a full 100-percent levy should be put on properly defined excess profits.

3. The protection of special privileges under the tax system through various loopholes should be ended. I refer to the well-known issues of the mandatory joint income-tax returns for husband and wife, of tax-exempt securities, and of percentage depletion allowances. I include the Treasury suggestions to increase estate and gift taxes. The Secretary of the Treasury and his experts have already discussed these matters with you at length. I am sure that the members of this committee have heard all of the arguments pro and con on each of these issues. I shall not burden the committee by repeating these arguments.

As a representative of labor, however, I would urge upon you the special significance of these issues at this time. In the first place proper action on these matters would increase the revenue of the tax bill by almost $1,200,000,000. This fact alone should lead you to search diligently for the ways and means of closing these loopholes and taking in this revenue.

I am aware that complications in each of those issues may be found. I am aware that with regard to each of these matters there are powerful groups which, feeling that their special advantage may be lost, have developed powerful lobbies with respect to each individual proposal. It is the considered judgment of my organization, however, that the situation demands a statesmanship in tax legislation which would not seek for rationalizations and reasons not to close these loopholes, but would rather proceed with the doubtless difficult task of adopting provisions to eliminate these special privileges and bring to the war effort the considerable added revenue which would result. The elimination of these special privileges looms above all other considerations, if this committee is to establish the bona fides of a people's war by making the 1942 revenue bill a true instrument for victory.

In conclusion, let me say I realize that much I have said to you is old stuff—you have heard it over and over again. There is a new element which should be considered this year, however. Today, as never before, the workers of this country are conscious of the issues presented by tax legislation. They are watching you as you deliberate over these matters. Their publications have discussed the tax bill for many months. Taxation has been a subject of discussion and resolutions throughout the entire labor movement, including the A. F. of L. and the Railroad Brotherhoods, as well as the C. I. O. While not being tax experts, the workers are watching your actions in regard to raising the needed revenue for the war, taxing large incomes of corporations and wealthy individuals, and closing loopholes. Your action of yesterday in refusing to close the loopholes provided by separate income tax returns and through ownership of tax-exempt securities will be discussed by, and become the knowledge of, 11,000,000 disappointed workers in the country.

I urge you to reconsider this action. I urge you to approach the other issues in this legislation along the lines I have indicated. Should you do so you may be sure millions of workers in this country will find gratification and encouragement in the knowledge that you have made the 1942 revenue bill a strong instrument for victory.

The CHAIRMAN. All right, Mr. Nixon, thank you for your appearance here.

We will hear one additional witness before recessing.

Miss Eleanor Fowler.

Mrs. KATZ. I am Mrs. Katz. I am appearing in Miss Fowler's place.

The CHAIRMAN. You are appearing for Miss Fowler?

Mrs. KATZ. Yes.

The CHAIRMAN. Very well, you may proceed.

STATEMENT OF MRS. JULIA KATZ, REPRESENTING THE CONGRESS OF INDUSTRIAL ORGANIZATIONS WOMEN'S AUXILIARY

Mrs. KATZ. I am appearing here as the national director of the Congress of Women's Auxiliary, C. I. O. We are the organization of the wives of C. I. O. members in all of the unions of the C. I. O. and in all of the industries in war production in almost all parts of the country. I came here this morning direct from Wheeling, W. Va., where I was attending the third annual conference of the West Virginia Council of Women's Auxiliaries. The women assembled there asked me to bring back to this committee the following message:

We miner's wives of West Virginia want to win the war. We are giving everything we have to help win the war. We are sending our boys into the Army and we tell them to fight hard and beat Hitler. We know that they are fighting hard. They are tough coal miners' sons, and they are afraid of no one. But they have got to have the guns and bullets and tanks and planes to fight with. We want the Congress of the United States to give them the materials they need to smash the Axis and the Japs. We want them to have all the materials they need, not just some of them. If you take two and one-half billion dollars off the tax bill, you take so many guns and bullets out of the hands of our sons on the battlefields.

We miners' wives see our husbands go down into the mines and they are working harder than ever digging coal for industry. In our State this year many miners were killed and our auxiliary sisters widowed by mine disasters while digging

coal to win the war. The Government nutrition program tells us we must feed them nutritious food to keep them strong to work for victory. Well, you cannot buy good nutrition in the company store on miners' pay now, and if you put a sales tax on, or put taxes on those who make too little now to get by on, you are going to have less coal, because our men will not have the strength to dig and haul it.

We try to keep our children so the war will not hurt them more than we can help. Our homes are not fit, we do not have money to feed and clothe and buy their books. We don't have money for doctors when they are sick. Our wages have to pay off old debts, too. If you put a sales tax on, you tax our children's health.

We miners' wives think that President Roosevelt is right. We know we could live pretty well on $25,000 a year. We think that those who have more and those who are making profits in this war should pay everything over what they need to live on, just as we are doing, to buy victory for our country. If Hitler wins their money will be lost; if we have to sacrifice our health and energy, we will not be able to produce for victory, and it will cost everybody the freedom and liberty for which our boys are dying today.

We miners' wives ask you to pass a tax bill that will give everything that America has to give to the war program and that will keep the workers strong enough to work and fight and give to victory.

This message comes from a group of women who, in spite of every obstacle to effective patriotism, are daily demonstrating their loyalty and self-sacrifice. We feel it warrants your most serious consideration. Their sentiments are shared and perhaps better expressed by similar groups of workers' wives related to unions in all the fields of war production. I thought that this particular statement would be most effective, because it comes from precisely that group of women who have given more under worse obstacles to the civilian defense effort, to the war effort, to the war relief effort in their community than almost any other group.

The Congress of Women's Auxiliaries of the C. I. O. to which these women are affiliated embraces the organized wives of C. I. O. members in every industry and in all parts of the country. As Americans and as women we have pledged our organization to the single aim of helping to win the war. In addition to all the tasks and sacrifices which we share with other women in the Nation, we have the additional responsibility of keeping our men strong enough to work, fight, and give to victory. In one month of this year—and this is the finding of the Gallup Poll—3,200,000 workdays were lost to war production because of absenteeism due to illness. In this length of time we could have built 3,200 light tanks, 448 medium bombers, or 2 heavy cruisers. Dr. Victor Heiser, who is the medical consultant to the National Manufacturers Association, states that only 10 percent of all absenteeism due to illness has its cause in industrial hazards. Ninety percent of the time lost in our war-production program results from a combination of factors, including poor housing, medical attention, and malnutrition. The President's Nutrition Conference held last May found that "malnutrition is more prevalent among families in low-income classes than those in high." It included in its recommendation for combatting widespread malnutrition, which threatens to create a production lag, that "as a defense against malnutrition the tax burden on the lower income groups should be decreased. No taxes should be levied on incomes insufficient to provide an adequate family diet. Sales and other excise taxes on food and other necessities of life should be eliminated."

Those are the findings of a conference called by the President of the United States in May 1941. Its 900 delegates consisted largely of

manufacturers' groups, of experts in various fields of health and nutrition, of representatives of Government services, and of industries concerned with the problem, and it does not represent labor's point of view unsupported by objective facts.

Recently a study made by the National Research Council warned that a serious production lag may occur because the means are lacking whereby workers in war production may replenish the energy expended in our present and ever-increasing production pace. Our national organization has enlisted the participation of our thousands of members throughout the country in the Government's battle against malnutrition. As workers' wives it is our most direct contribution to maintaining uninterrupted production. The enactment of increased taxation on low-income groups either by drastically lowered exemptions or by a sales tax will cripple our earnest efforts and will take its toll in increased absenteeism.

Mr. Morgenthau has asked for self-denial in the enactment of tax legislation. We assure you, gentlemen, that we are ready for all self-denial that is not also the denial of our strength and efforts toward winning the war.

The Congress of Women's Auxiliaries for these reasons gives its wholehearted endorsement to the tax program of the C. I. O. Included in that tax program is the provision for joint income-tax returns for married couples. Our organization has, since long before Pearl Harbor, enjoyed a program of unified effort with all other patriotic women's organizations in a program for victory. We cannot, however, agree with the contention that a joint income-tax requirement is in any way a violation of the rights of women. The absence of such a requirement now offers a special privilege to both husbands and wives in upper income brackets. Its enactment would restore to the Government money needed for the war effort, from both husbands and wives with high personal income. It would remove a discrepancy between the taxation of low income families and high-income families.

The CHAIRMAN. I thank you very much for your appearance.

The committee will recess until 2 o'clock. We will have a rather full afternoon, but I think we can finish this afternoon.

(Whereupon, at the hour of 12:10 p. m., the committee recessed to 2 p. m., of the same day.)

AFTERNOON SESSION

(Whereupon, at 2 p. m., the committee met, pursuant to recess.)

The CHAIRMAN. Mr. Royal Little.

Mr. LITTLE. Yes, sir.

The CHAIRMAN. You may take that chair, if you prefer to.

STATEMENT OF ROYAL LITTLE, PRESIDENT, ATLANTIC RAYON CORPORATION, PROVIDENCE, R. I.

Mr. LITTLE. My name is Royal Little, president, Atlantic Rayon Corporation, Providence, R. I.

I am making this appearance as an individual as well as a corporate taxpayer, and before making any general statements in regard to the House bill, I would like to make a few specific comments on some of the detailed provisions.

On section 108, the taxable period embracing years with different laws——

The CHAIRMAN. Do you prefer to stand?

Mr. LITTLE. Yes, sir.

The CHAIRMAN. You prefer to stand?

Mr. LITTLE. Yes, sir.

The CHAIRMAN. I hope you gentlemen will note these specific recommendations that are made.

Mr. LITTLE. If you analyze the effect of this provision you must agree that it is unfair and opportunistic in nature.

This change from fiscal to a calendar year basis will not, over a period of years, bring in 1 cent more revenue than the present basis. It merely brings taxes in sooner.

When the war is over and taxes are reduced, the fiscal year corporations will have to pay war rates for a longer period. In addition, these examples show how unfair this change would be to many companies. One company in which I am interested, we estimated early in our fiscal year, based on business booked and the tax rates in effect last year, that in our fiscal year ending in September 1942, we would have sufficient earnings after taxes to be safe in spending an extra $200,000 for productive equipment to increase our war production. It happens that this is a weaving mill. We bought the looms. They have been installed and now the bills are payable for these looms but under the new tax law we will be required to set aside an extra $150,000 in taxes.

In other words, it appears that we have spent our earnings twice. What can we do? What shall we use for money to pay these unplanned taxes? There is a mortgage already on the plant and equipment, and we cannot borrow more. Why should we be penalized for acting in good faith to expedite war production, and then have the rules changed retroactively?

In another company our fiscal year ended June 30. Our board declared dividends—approximately all of our earnings based on last year's tax bill. We have no additional surplus from which to declare dividends in excess——

The CHAIRMAN. Did you pay out the dividends?

Mr. LITTLE. We actually paid out the dividends.

The CHAIRMAN. You actually paid out the dividends?

Mr. LITTLE. But we had no surplus in addition from which to pay more than the current year's earnings. If we are forced to pay taxes on the new basis for the first 6 months of this year, our directors will have been guilty of declaring dividends out of capital—a direct violation of the law of the State in which we are incorporated. We, as directors, have acted in good faith. Why should you subject us to possible shareholder suits and fines by retroactively changing the rules after the game is over?

There must be thousands of other cases of corporations which have bona fide commitments to spend money made before the proposed change.

I suggest, therefore, to remedy this situation that section 108 be removed and the following provision be substituted:

Corporations shall not be permitted to change their fiscal year for tax purposes if by doing so, in the opinion of the Collector of Internal Revenue, such corporations' current or future rate of tax will be reduced.

I would like to reiterate on that point that if you follow that through, you can easily see that you will not, in the long run, get any more money in taxes by changing back to a calendar year. You only move forward the date that we have to pay our taxes, so long as you do not permit us to change our fiscal year basis.

The CHAIRMAN. Well, this is a nonrecurring gain, anyway, if there is a gain, to the Treasury. It only happens one time. It is not like a change in rate that runs right on through your tax. It is a nonrecurring gain or loss and, as you say, if you assume the taxpayer is going to remain in business and taxes are going to shift from year to year, it is practically as long as it is broad.

Mr. LITTLE. The taxpayer ultimately has to pay the tax.

The CHAIRMAN. The strongest reason, Mr. Little, that appeals to me in support of it is this: That earnings may be higher this year than in any subsequent year unless it should be next year, and that taxpayers simply will not have the money even if there is a gradual decline in the rates, they won't be earning the same, and the other one, there is a competitive advantage in favor of the fiscal year man where he has a large part of his fiscal year in 1941, he has this other competitive advantage over his competitor who is on a calendar year paying at the higher rates on maybe peak earnings.

Mr. LITTLE. That advantage will be taken away on the tail end of whatever we are in now.

The CHAIRMAN. That is true.

Mr. LITTLE. It will equalize.

The CHAIRMAN. That is true, if earnings remain high it would be washed out, I would say. The thing that appeals to me is that it is a nonrecurring loss or gain to the Treasury. It is a one-time transaction. My mind is open on it, and I want to hear from the joint staff on it.

Mr. LITTLE. It does work a great hardship in many cases, though, where we have already spent our money or used it somewhere else.

The CHAIRMAN. And I suppose you have never selected the fiscal year with any thought of taxes?

Mr. LITTLE. The corporation I have quoted here has always had this fiscal year. One of them has been in business for about 90 years.

The CHAIRMAN. So it couldn't have been selected with any purpose of avoiding taxes?

Mr. LITTLE. No. And my suggestion here at the tail end would prevent corporations in the future from moving ahead or back to gain a tax advantage.

The CHAIRMAN. In other words, putting the discretion in the Commission to allow or disallow the change from one year to another?

Mr. LITTLE. Yes.

The CHAIRMAN. Thank you very much on that point.

Mr. LITTLE. The next point—there has been some discussion, and I haven't had a chance to go through the bill on it to see whether there is anything in the bill, but I would like to get this across because I think it is important, on possible tax inducement to buy bonds which I understand has been discussed by the committee.

The CHAIRMAN. I want to say to you that there isn't anything in this bill now.

Mr. LITTLE. While I am here, could I state this much: To offer tax deductions to the extent of bond purchases would be most unfair. As examples: The large corporations who have millions in surplus cash available today, these companies may, under the new law, pay as much as 90 percent of their top earnings in taxes. If they could use surplus cash to buy war bonds and get tax deductions, they would, in effect, be buying United States bonds at 10 cents on the dollar, and if the bonds carried a 2-percent rate, the Government would be paying 20-percent interest for its money. This would be grossly unfair to companies using all their available funds for war purposes and being unable to put funds into bonds. Also I doubt if Uncle Sam's credit has yet sunk to the point of paying 20 percent for money.

Then my own case. I happen to have $10,000 in cash that I have saved up. If you put such a bond inducement idea in the law, I could buy them on a basis of 50 cents on the dollar, while the working people in my plants have to buy them at par. There are many cases where people who have got cash in hand could take advantage of that to the disadvantage of those who are paying it out of earnings.

The CHAIRMAN. There is no provision in the bill looking in that direction. The nearest approach to it is the suggestion that there be a post-war credit as against the high excess profits.

Mr. LITTLE. As far as the individual tax rates are concerned, I don't think they are high enough. I would like to take a couple of specific examples again.

The CHAIRMAN. Are you speaking of the individual——

Mr. LITTLE. The individual tax rates. We have a man—I will call him Bill—who works in our dyehouse. For 5 years before the war his average pay was $1,140. It happens that due to short time we have had to pay high rates to hold the men in those departments. His average hours had been 24 per week before the war. If you take that $1,140 base that he earned before and adjust it by 15 percent to increase it to a new base for a higher cost of living under present conditions, you get a figure of $1,320, but today, when we are busy working 48 hours a week at the same high rates, he will earn this year, at the rate we are going, $2,970 approximately. So, deducting from that the $1,320 adjusted 5-year basis, it leaves him $1,650 more than his 5-year average after adjusting for the higher cost of living. Under the tax proposals, he would only have to pay $260, or 15.7 percent of this clear excess income.

In my opinion many workers of this class could easily pay at least half of this excess income over what they had previously earned and what they had supported families on, and in his case, instead of paying $260, he would then pay $825, and still be better off than he had ever been before.

Another very interesting case is that of our chauffeur. When it looked as though we were going to have to prepare for even higher taxes than you now propose, my wife and myself decided that we

would let the chauffeur go and get him work in a war plant. We didn't like the idea of keeping a man just chauffeuring when he could be doing mechanical work.

We used to pay him $1,800 a year, buy his uniform, and pay his phone bill, and a lot of other expenses. He has two children and a wife, so he paid no income tax. He is a good mechanic, he is working long hours today. He is making from his new job at the rate of $4,525 a year. We also put our cars up, and we pay him a retainer of $1,200 a year to look out for our cars, so that he is getting $5,725 a year today. Now, if you make the same application there and add $270 for increase in the cost of living, bringing him up to $2,070, you still see that he is receiving at the rate of $3,655 more per year than he ever received before.

Under the new proposed bill he would be taxed $759.50. Again I don't think that is enough.

There must be at least 10,000,000 war workers whose true realized income after adjustments for higher cost of living is far greater than it has ever been before and under the proposed law the Government is not recapturing nearly enough of that excess.

For example, if there are 10,000,000 workers and if my contention is correct, and you could obtain, without hardship to them, an extra $500 apiece per year over and above the proposed rates, that would amount to $5,000,000,000 in the aggregate.

Senator VANDENBERG. How would you do that without penalizing the chap who hasn't had any such bonanza except as you applied the excess profits tax theory to individual incomes?

Mr. LITTLE. I admit that is going to be a hard one, except as there might be some increases in the white-collar man who has a standard of living that has not been so much distorted but there is a tremendous source of revenue that is being untapped right there that I don't think can be overlooked.

Senator VANDENBERG. If you applied the excess profits theory to individual incomes, you would achieve your purpose, wouldn't you?

Mr. LITTLE. That is correct. I would like to come back to myself again. My net income, taxable income this year, after deductions, will be something in excess of $20,000. Under the proposed tax law——

The CHAIRMAN. You are under the $25,000.

Mr. LITTLE. This is gross. Under the proposed tax law you only propose to take $7,000 of that. That is too damn little. I think I ought to pay nearer twice that amount, and I think I can. I think that there are probably pretty close to 150,000 people like me in the country.

Senator VANDENBERG. We ought to put a statue of you in the Statuary Hall.

The CHAIRMAN. What did you say your gross would be?

Mr. LITTLE. Well, the net taxable, subject to taxes, would be slightly over $20,000.

The CHAIRMAN. Slightly over $20,000?

Mr. LITTLE. Yes. Now, if you can get another $7,500 out of me and 150,000 people like me, there is another billion dollars for you.

The CHAIRMAN. If we can get it out of them whether they are like you or not, it would be fine.

Mr. LITTLE. I would just like to ask this hypothetical question: Why, under present conditions, should I be permitted to retain for myself more than, let's say, a colonel in the Army, who has approximately the same financial and personnel responsibilities that I have? If I left my job and went in the Army, I doubt, in the first place, if I could get a colonel's commission, but if I did, I don't see why running war plants, as I do, I should make substantially more than I would, and have left over for myself substantially more than if I were in the service.

Other industrialists may not agree.

Now, on the question of individual taxes, I would like to suggest much higher surtax rates throughout. In addition, I suggest stiff withholding taxes at the source. They should begin at low rates in nearby months and be stepped up monthly until by the end of 1943 the following maximum rates are reached: 10 percent gross income tax at source on all salaries, wages, commissions, professional income, entrepreneural withdrawals and other earned income, and 20 percent gross tax at the source on all dividends, interest, royalties and other return on invested capital.

The CHAIRMAN. That is, as an additional tax or to be credited against——

Mr. LITTLE. The simplest way is to take that off and only consider what you actually get as your income to report for tax purposes. It would save a tremendous amount of bookkeeping if it is done as a withholding tax which is paid over by the corporation and others who pay the money, as dividends or interest or wages or salaries are paid, have the deduction in bulk and have the individuals report only what they receive. Otherwise you get into tremendously complicated computations, and I see in the act there is a provision for a withholding tax which, in effect, is just an advance payment, and the way that is set up would probably take an extra hundred thousand people as bookkeepers that ought to be producing war goods. I think it is much too complicated.

The CHAIRMAN. Your suggestion would eliminate all that accounting on the part of the employee?

Mr. LITTLE. It wouldn't eliminate all of it, but it would greatly simplify it. The way it is worked out now, each corporation would have to be, in effect, a collector of internal revenue, and you would have to put everybody through the same questions to get them to determine their dependents and everything else.

Senator DAVIS. What additional cost would there be to the corporation that is collecting the taxes?

Mr. LITTLE. Do you mean if it were done on just a bulk basis?

Senator DAVIS. What would be the cost of collecting it at the source?

Mr. LITTLE. It would be infinitesimal in relation to the money collected. It is hard to express it in dollars and cents, but I doubt in our own case whether it would cost us more than two or three thousand dollars a year to collect what I have suggested than it does to handle it as at present, but under the proposal here, it is going to tie so many people up in nonproductive work and we need them to work. It is hard to find people to work and turn stuff out.

The CHAIRMAN. It looks like your suggestion on that point has a good deal of merit. I hope the staff representatives will note it so that we may give it further consideration.

Mr. LITTLE. I would also like to recommend a 10-percent retail sales tax on top of everything else. You will catch a lot more taxes there. Under present conditions, I don't think any source of revenue should be overlooked.

You probably wonder what the nigger in the wood pile is here, so now about corporation taxes.

The CHAIRMAN. We are waiting to see.

Mr. LITTLE. We must understand that corporation income as normally determined is not realized income. Corporation earnings are largely on inventory, receivables, equipment, and assets other than cash. It is for this reason that corporation taxes beyond a point are either uncollectible, or, if collected, will cause the forced liquidation of corporation assets and seriously restrict the company's volume of sales and ability to produce.

I believe that the rates of corporation taxes proposed in this bill will seriously jeopardize the war effort. It will hinder the rapid expansion of production and sales so urgently needed. Except in the case of the most wealthy corporations whose credit and facilities are approximately limitless, it will force the future concentration of Government contracts in these wealthy companies and reduce the work to be done by small concerns and by companies like my own where future credit cannot be obtained due to our inability, under proposed tax laws, to repay bank loans out of earnings.

In order to emphasize this condition, I am going to pass out copies, if I may, of our two companies' balance sheets. There is one small sheet inside—I will wait until those are passed out.

There is a large one which is the parent company—Atlantic Rayon Corporation—a small one which is a subsidiary, recently started to make parachutes, human escape chutes for the Air Corps.

The procurement requirements of the Air Corps have increased so tremendously on that particular item that we started a plant to make parachutes and the parent company put $100,000 into the Atlantic Parachute Co. in order to finance the purchase of the machinery required.

We have received a $3,000,000 subcontract from an established parachute manufacturer who is showing us how to make chutes, to make the human escape chutes for the Air Corps. After having installed our machinery, we spent nearly 2 months trying to finance this business.

As a subcontractor we were not eligible for Government advances, and most banks felt it too great a gamble for them to finance our inventory requirements and starting up losses in view of the proposed tax law.

If the corporation tax rate had not averaged over 50 percent of total earnings, we could have arranged financing in an hour, and we could have spent the balance of this 2 months producing chutes instead of trying to arrange credit.

Until our bank loans were finally arranged, the suppliers of over a million dollars' worth of parts and equipment which we have to use in making the chutes would not make shipments.

When we finally obtained bank credit, it was only on the basis of Atlantic Rayon Corporation, and all the officers of the parachute corporation subordinating all the salaries and administrative expenses of the parachute company to the banks.

In other words, the general manager of the plant who puts in 12 hours daily 6 days a week is not receiving one red cent in salary for running this job and cannot be paid until the loans are retired.

Fortunately, this man is patriotic enough to devote his full time to the job on this basis, and we are already shipping substantial quantities to the Air Corps, although the plant was not put into operation until May 1 of this year.

If we ever pay off our loans, I imagine the Federal tax collector may have something to say about getting his before our administrative expenses and salaries can be paid in cash.

In other words, with a new corporation of this sort going into a war industry, we are now in a position where I seriously doubt whether we will ever get even our original hundred thousand dollars back out of the company. We have gone into a new business which has required machinery which we cannot use after the war. We have lost, in the first 6 months, including our starting up expenses and training our people, $174,000. We have got to make that up first, and it just shows, under a proposed law of this sort, how impossible it is for anyone to be successful in a new undertaking on a war industry, and it also shows why practically no businessman today would dare risk new capital in a venture of this sort, because the chances of ever getting even his capital back are so slim.

I cannot emphasize too strongly to you that through the corporation-tax provisions of this bill, you are driving more and more war business into the control of wealthy corporations and making it practically impossible for small concerns to finance Government work, even if they are fortunate enough to get it.

You are all familiar with the fact that direct Government advances on war work are no longer made against new contracts. In its place are substituted so-called "V" loans under which the banks assume 10 percent of the risk, but even with that limited risk, the banks would rather earn a lower rate on a sure thing—meaning lending big companies at a lower rate—than to take a hundred to one shot on a small war contractor strangled with this tax bill.

I, therefore, suggest the following simplification of the corporate-tax structure to replace all types of proposed corporation taxes:

1. A flat 50-percent over-all rate on all corporate taxable net income. This rate would produce, in itself, large revenue.

2. Twenty-percent tax at source on all dividends, interest, and so forth, paid by corporations as previously proposed under the individual taxes. Obviously, if the earnings have come out into cash and are available for distribution to stockholders and bondholders, this tax would not jeopardize corporation credit.

3. Change section 102 for unjust accumulation of surplus. Make the effective rate 95 percent, and make the tax mandatory in cases where corporation earnings show up as increases in investments and other assets not required in the ordinary conduct of the business, increases in cash, cash surrender values, marketable securities, and prepaid expenses. In other words, going back to my theory that you are

now taxing unrealized profits at too high a rate, but in order to catch profits which are realized, you can supplement a reasonable high flat-rate tax with a tax on dividends and interest when paid and catch anybody who makes a lot of money and accumulates it in a corporation.

I claim that through these three taxes you would catch all of the true realized profits of all corporations, large and small, but would not jeopardize, through the taxation of unrealized profits as proposed in this bill, the credit of all corporations, except the wealthiest with excess cash reserves.

You see, under this bill, the corporation in the fortunate position of having several million dollars of surplus cash, as many large ones have. You can't destroy the credit of that corporation even if you taxed 100 percent of their earnings, and that is why most of the emphasis has been in trying to reach the corporations of that sort and drawing the tax provisions to reach those corporations, but in effect the more you try to hit them, the harder you hit the smaller ones, and those like my own which are using borrowed money to the greatest possible extent.

In summary, I wish to emphasize my general position regarding the current tax problem, believing that perhaps millions of other taxpayers in the country really feel as I do.

We are faced with Government expenditures of $77,000,000,000 during this fiscal year. Tax income may reach $24,000,000,000 under the proposed planned tax, leaving $53,000,000,000 to be raised through the sale of bonds. That is only 31 percent of our expenses in taxes, and it is not enough.

To be in line with England, Germany, and other warring countries, we should collect between forty and fifty billion dollars a year in Federal taxes annually. This can be done. We would still be paying less than 50 percent of our total national income in Federal, State, and local taxes.

What is the alternative? A staggering three hundred to four hundred billion dollar debt when the war is over, and certain repudiation.

Gentlemen, I am standing before you pleading that you be realistic and that you tax me and our fellow citizens two or three times as much as proposed under this tax bill. We are willing and eager to take it, but have you the courage to do it?

I thank you.

Senator DANAHER. May I ask Mr. Little to take a letter I have here and comment briefly, if he will, on it, from the standpoint of a practical manufacturer? Do you have such a schedule that would admit of his taking 5 minutes to do that?

Mr. LITTLE. I think I had better take it outside.

Senator DANAHER. I was addressing the chairman.

Mr. LITTLE. I am sorry.

The CHAIRMAN. How is that?

Senator DANAHER. I say: Do you have 5 minutes that we could permit Mr. Little to do that?

The CHAIRMAN. Yes. Go right ahead, Senator

Senator DANAHER. I would like you to do it, if you will, please, and if you will read it to the committee, it is pertinent and bears in general on what you have talked about.

The CHAIRMAN. Do you wish Mr. Little to do it now or look it over?

Senator DANAHER. If he chooses to, I think he could do it now.

Mr. LITTLE (reading):

Senator JOHN A. DANAHER,
Senate Finance Committee,
Washington, D. C.

My DEAR SENATOR: This company, for 70 years, has been making high-pressure compressors for oxygen, hydrogen, helium, welding, torpedo charging, and many other services.

We are building many of these compressors for the United States Navy and they are increasing their orders. Many of them have been shipped to Pearl Harbor, Dutch Harbor, Umalaska, and other outlying bases.

The following is a brief outline of the condition of our company as well as the future outlook:

Capital:	
Bond issue	$213,000
Stock issue (approximate)	20,000
1941:	
Business	523,000
Profits before taxes	58,000
Taxes	30,000
Profits after taxes	28,000

Expansion: All of this went to expansion to make more and better machines.

Profit left over: None at all.

Dividends: Stock has not paid any for about 20 years. All earnings have been plowed under.

Future taxes: If taxes are made higher than 1941 we will not and cannot expand, or make improvements.

1941 schedule: It is high as this company can stand and progress—even paying no dividends.

The United States operation: If the United States took this company over, expenses would increase. The United States Treasury would then get less out of it—not more.

Tax rate for 1942: It should not be higher for companies of this type than the 1941 schedule.

Borrowing money: We cannot borrow or raise capital for expansion, even under the 1941 tax rate. Until we see what the tax situation is, we cannot put money (past earnings) into anything charged as an asset. If we ordered extra machines and our profits were mostly taxed away, we would have no money to pay for them and would have to go into receivership.

Treasury tax plan: It will hold us back and the United States will lose—not gain.

Photographs: Enclosed are photos of:

1. Pearl Harbor compressor for torpedo charging.

2. The improved boring mill which took all our profits of 1941 (after taxes) while we paid only 4 percent on our bonds and nothing on our stock.

1941 tax rate: It should not be increased for companies like this with low capital. It is low because company failed twice and stock capital was wiped out.

Present financial situation: The cash to buy the above boring bill is still owed to the bank, secured by accounts we hope will be paid. We can scarcely get a small reserve, even with taxes like 1941.

Secretary Morgenthau's plan: He may extract a few more dollars the first year, but after that, much less. He would kill the "goose that lays the golden egg." He should be made to see it.

Sincerely yours.

Senator WALSH. What is the name of the company?

Mr. LITTLE. Norwalk Co., South Norwalk, Conn.

Senator WALSH. Is it a family company or is it generally owned?

Senator DANAHER. It is a small company but with general ownership, with local investment.

Senator WALSH. If it is a family company, it would cover the earnings by substantial salaries to members of the family. If it is a generally owned concern, that might not be possible.

Senator DANAHER. In view of the bond issue outstanding of some $213,000 on which 4 percent has been paid, it is apparent that whoever the bondholders are, whether banks or otherwise, are going to have something to say about that, but my point to you, sir, in asking you to comment on it: How you are going to relate the program you recommend to a low capital corporation of that character?

Mr. LITTLE. Well, I think in the first place, his tax rate would not exceed 50 percent of his earnings under my plan because he is paying no dividends. He would pay a small tax on his bonds, but that wouldn't come out of him. That would come out of the bondholder, and he obviously isn't guilty of unjust accumulation of surplus so that he wouldn't be subject to the 95 percent rate there.

I do think there has been a great misconception of the ease with which taxes can be pulled out of corporations. It looks like an easy place to—relatively few of them—and it is an easy place to go in and dig in, but under this proposed bill the results are going to be disastrous, and when the war is over you are going to have fewer corporations than ever and they will be the strong ones that have the cash reserve now and can go through if necessary without any earnings.

Senator DANAHER. If we take even the rates under this present bill, this company won't be able to expand even in war production, will they?

Mr. LITTLE. No; because no one will lend them the money.

Senator DANAHER. And yet that is an exact type of an instance where we ought to encourage in every way within our power, it seems to me, the expansion of the plant.

Mr. LITTLE. I would just like to reiterate again that the higher the corporation rates go the more it is going to favor the bigger corporations.

The CHAIRMAN. You mean the stronger corporations?

Mr. LITTLE. Yes; the ones with the big cash reserves that went into the war in very strong financial condition and who have the money to finance their own expansion, who have so much capital that they can easily obtain all the credit they need for expansion, but in our own case, if you will look at this statement—I didn't call attention to this long one here—we have reached the end of our rope already on expansion for war purposes.

As you can see, taking the current assets of a million-nine-something and the current liabilities of a million four, we only have in net working capital about a half million dollars, and the trouble is that on the war work which we do, the material which we use is so much more expensive per pound—we are using nylon, for instance, which runs $2.50 a pound as against rayon, our normal business product, at 50 cents a pound—that to fill our machines up and handle the volume of production that we can and should be doing, it takes five times the inventory that we normally run.

Now, you just can't get the banks to go on lending you millions and millions. There is a limit. And when our statement begins to get up here to about 1.1 to 1 ratio, the banks just tell us to shut down some machinery and not try to do so much war work.

I don't think that is constructive.

Senator WALSH. Is your contract with the Government a negotiated one?

Mr. LITTLE. The parachute company is a subcontract with a parachute manufacturer. That is a subcontract. The rayon company has Air Corps contracts to supply the materials that go into parachutes—the canopy cloth, shroud lines, sewing thread, and other materials.

Senator WALSH. Those are probably negotiated contracts.

Mr. LITTLE. Those are negotiated contracts.

Senator WALSH. And yours is with another contractor that is the main contractor?

Mr. LITTLE. These contracts are negotiated with the Air Corps direct, but that is a serious situation, gentlemen, where we have productive capacity that we can run but we can't get the money to run it full because of the additional cost of equipment here.

If we were allowed to make and retain for the repayment of loans a fair return, the banks would be willing to go ahead and lend money to companies like us to get us going, but it just is too much of a gamble.

You have got to lend companies on a thin margin like this, to lend them several million dollars as they would have to, to keep us running full, is taking a hell of a chance today. If we make any mistakes and don't deliver or deliver poor quality, the margin is gone. If we make some money on it, taxes take it, so the banks figure that they can't get paid out, they are not sure of getting paid out.

Senator DANAHER. First let me thank you for your attention to my previous inquiry. I wish to ask you one more: The name of the general manager of the Atlantic Parachute Co. is Mr. Royal Little?

Mr. LITTLE. No. Mr. Eliot Farley, who is the fellow that took on that job. He had retired from active work and I got him back in harness again, and he is the kind of fellow that doesn't give a damn whether he gets anything or not, but I don't think it is fair for him to work as hard as he is without some cash payment.

Senator DANAHER. I don't think he is any more of a patriot than you are.

Mr. LITTLE. I don't know about that.

The CHAIRMAN. Thank you very much.

Mr. Kellogg.

STATEMENT OF HOWARD KELLOGG, PRESIDENT, SPENCER KELLOGG & SONS, INC., BUFFALO, N. Y.

The CHAIRMAN. Mr. Kellogg, you are representing Spencer Kellogg & Sons?

Mr. KELLOGG. Yes. Shall I read from my statement?

The CHAIRMAN. Yes, sir.

Mr. KELLOGG. My name is Howard Kellogg. I am president of Spencer Kellogg & Sons, Inc., of Buffalo, New York. I have been with this company for 39 years.

We buy flaxseed and soybeans from farmers in this country, and some castor-oil beans from Brazil, crush them and sell the oils mainly for industrial purposes, but the soybean oil is sold largely for edible purposes. We pay the American farmers approximately $28,000,000 a year for flaxseed and over $10,000,000 for soybeans.

Our business is not a get-rich-quick business. We paid in dividends this year approximately 1.6 percent of our sales, and we reinvested in machinery and equipment another 1.6 percent, which used up all of our profits. Our profits, after taxes, this year were almost the same, just a little larger, than our profits after taxes in pre-war years.

Only a small percentage of our sales represent contracts with the Government—something around 2 percent, most of that being for lease-lend purposes. In addition to the oils for edible and industrial purposes, we also sell a meal from these seeds and beans to farmers for feeding dairy cattle and other livestock. You can see, therefore, that our business in regard to its use, its volume, or its profits, is in no sense a war baby.

We have received several staggering blows this year which I wish to explain to you, and then on top of them the Ways and Means Committee of the House has unwittingly dealt us another staggering blow by changing the fiscal year method of calculating the tax, which basis we have been on for all our history of nearly 50 years in Buffalo, 30 years of which has been in corporate form. Before designating the specific effects of this fiscal year change upon our business, I should like to tell you of the other disasters which have befallen us due to the war. In some respects they might be called war casualties.

Some years ago we invested approximately $150,000 in a plant in Hankow, China, for China wood oil. A pipe line runs from this plant to the water front so that the oil could be loaded on tankers or barges in the most efficient manner. The Japs now control Hankow and they have this plant. As you may surmise, they have not offered to pay us anything for it. We believe that the United States bombers in raiding the Hankow water front have destroyed the plant. We hope they have, as we hope that they will destroy everything which will help the Japs. But we have no hopes of American bombers paying us anything for this plant. It was in the French Concession in Hankow, and as we had reason to believe that the French might not be able to protect it, we had liquidated our inventory, so that our loss was limited to the plant.

Some years ago we also invested $850,000 in a plant in Manila, P. I., to produce coconut oil. Because of our faith in the strength of the United States, we felt that this plant would remain in United States territory, and when it was taken over by the Japs, we had an inventory of a million dollars of copra and a half million dollars of coconut oil. The Japs have not offered to pay us anything for that, either.

These losses were none too pleasant, but we took them with a smile, saying, "Such is war."

If we had not already suffered these losses we might not have worried so much about the change made by the Ways and Means Committee, with respect to corporations that would ordinarily report profits on a fiscal-year basis, which results in our having paid out in dividends approximately $710,000 more than we earned this year, after consideration of plant expenditures.

Taking all this together, however, we believe that we are being asked to carry more than our share of the worries and burdens.

I should like to take a few minutes now to say specifically how this change affects us.

Our fiscal years ends on the last Saturday in the month of August. Our year is divided into 13 periods of 4 weeks each. Our reason for closing our fiscal year in August is that it is the close of a complete cycle of operations. Our business consists of: First, buying raw materials from the farmers; second, converting it into oil and meal; and, third, selling these products. We buy our raw material from the farmers, beginning the latter part of August and continuing until the latter part of December.

The conversion and the sale continues and is completed about the middle of the next August. August to August, therefore, represents a complete cycle of 1 year's operations. If we closed our books on December 31, we would then have most of our raw material on hand. Also at that time we would be extremely heavy borrowers at the bank, these temporary loans being represented by our large inventory. It is absolutely essential that our fiscal year cover the periods just mentioned.

Our sales for this fiscal year are estimated at approximately $58,000,000.

Our earnings before taxes are estimated at	$4,000,000
Taxes estimated as per House bill	2,843,000
Earnings after taxes	1,157,000
Unusual capital expenditures, 11 periods	900,000

A sizable portion of this capital investment was made for a new plant in Decatur, Ill., to extract the largest possible amount of oil from each soybean. This investment was deemed so desirable by the Government that we were favored with a very high priority which enabled us to construct the plant this year.

The construction was started before this year, but it was finished this year. A portion was spent for special equipment to produce a substitute for China wood oil. All of this oil is sold under priorities and is needed for war use or war production. In other words, this capital investment may not be profitable but was done because war production and use demands this substitute. We do not have the amortization privilege which applies to the companies producing armament, airplanes and so forth.

This left us	$257,000
Our total dividend payments for the year were	967,504
This leaves us short	710,504

Last November we made a loan at the bank of $2,500,000, to be paid off at the rate of $420,000 per year. The purpose of the loan was to take care of our working capital requirements. We are paying the farmers higher prices for our raw material and we are also paying higher wages, each of which meant that we must have more working capital. The above shortage of $710,000 means that we will have that much more difficulty in paying off our working capital loan.

As previously stated, we have always been on the fiscal year basis. We have played the game according to the rules during our entire history. We believe that our business has been a distinct asset to

agricultural sections of our country. We have tried to operate at a profit but our profits have never been exorbitant, our dividends have never been large.

Ever since 1934 we have believed that your committee and the Congress did not favor going retroactively into previous years and materially increasing the tax rate.

Here is what our figures will be if you do not break this long-established precedent this year:

Estimated sales	$58,000,000
Estimated earnings before taxes	4,000,000
Estimated taxes	2,230,000
Estimated earnings after taxes	1,770,000
Unusual capital expenditures	900,000
Amount left	870,000
Dividends	967,504

Section 102 provides in substance that all money properly available in dividends must be distributed in dividends. We now find that we distributed $710,000 more than was available for dividends and plant expenditures, and we also have the job of trying to raise that much through additional loans. Since this $710,000 new burden caused by the House bill comes directly out of our working capital, it must be replaced by additional borrowing if our business is to be financed adequately.

If this change was made because you believe that some companies have changed from the calendar year to the fiscal year merely for the purpose of saving taxes, you can stop that without killing 50 sheep along with each wolf. If a company wishes to change to the fiscal year it can do so only with the permission of the Commissioner of Internal Revenue. If, when new corporations are formed, they also must secure the Commissioner's consent, you will then have ample protection against improper selection of the fiscal-year basis.

We have to keep our books on the present fiscal-year basis, and we would very much urge you not to change the fiscal year as requested by the Ways and Means Committee. In addition to the financial difficulties, it presents many bookkeeping and accounting difficulties.

If you believe that it is absolutely essential for the good of the United States to make this change we then ask that it shall not be done retroactively. We have already had two staggering blows this year, and we would like to ask that we be given a little breathing space by postponing this until next year.

We were not so surprised at losing Hankow. We were prepared for that loss, and lost only the land and buildings, but we have had to spend money in this country to manufacture a substitute oil.

The loss at Manila was heavier, and we were less prepared for it. We had depended upon the might of the United States to retain Manila. Being unprepared, we lost $1,500,000 in inventory, besides the loss of the buildings and equipment.

While we are not crying over this loss, and never have, we might say because we had depended upon the United States a million and a half of inventory was there and was lost, and because we depended upon the tax law of the United States affecting fiscal-year companies, which has been unchanged since 1934, and because we believed that it

would never be changed retroactively, we made our capital expenditures and paid our dividends in accordance with the above understanding and will now find ourselves out $710,000.

I trust, therefore, that you will see the reasonableness of our request when we ask that you at least give us a little breathing space and let this change begin next year instead of making it retroactive.

Senator BYRD. In connection with your losses in China and the Philippines: Isn't that, to some extent at least, in the case of inventories, deductible from your income?

Mr. KELLOGG. Yes; they are.

Senator BYRD. That would reduce the income you estimated here, wouldn't it?

Mr. KELLOGG. No, sir. That is all taken into consideration in the figures I have given in there.

Senator BYRD. I mean, deductible from the income tax.

Mr. KELLOGG. We have done that.

The CHAIRMAN. You have taken that into account in arriving at your tax?

Mr. KELLOGG. Yes; we have in our figures.

Senator BYRD. Then, as estimated in this bill, it would still be $2,843,000?

Mr. KELLOGG. Yes, sir. Still allowing for the fact that it is deductible.

Senator BROWN. You feel that the change should be effective in the tax year of 1943, and payable in March under the present system, in 1944?

Mr. KELLOGG. That is what I feel.

Senator BROWN. Would you have any objection to the change if it were so arranged?

Mr. KELLOGG. No; I wouldn't. I wouldn't object. If you gentlemen think it is best for the country, why, let's have it.

I am just saying, in this special case, that we did rely on the fact that you have never changed the tax laws retroactively.

Senator BROWN. I think there is a great deal of justice in your position, but I don't think it is unique in your business.

It is true in a great many businesses.

Mr. KELLOGG. I think it must be. Certainly we had no idea, and it came rather as a bombshell to us when we understood that there was a prospect of making this change. It is quite upsetting.

We can take it, naturally—I don't mean to say we can't—but it seems to me that we were justified in going along the way we did, feeling that the tax wouldn't be made retroactive.

The CHAIRMAN. Thank you very much, Mr. Kellogg.

Mr. Robert Miller.

STATEMENT OF ROBERT N. MILLER, WASHINGTON, D. C., CHAIRMAN, EXCESS PROFITS TAX COMMITTEE, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. MILLER. Robert N. Miller, Washington, D. C. I am chairman of one of the committees, section of taxation of the American Bar Association. My committee is the excess-profits tax committee, and what I say will have to do only with excess-profits taxes.

The American Bar Association has directed us to present five recommendations in this particular field. The first four can be disposed of quickly.

The first recommendation is completely met already by this House bill, in that it extends the growth principle of computing base period income to acquiring corporations as defined in the law.

The CHAIRMAN. That is taken care of?

Mr. MILLER. Taken care of.

The next one is practically taken care of. The American Bar Association recommended the declared value excess-profits tax, together with the capital-stock tax to be repealed. The House has not done that, but they have made every year a declaration year, which was our alternative request.

The CHAIRMAN. Giving you an annual declaration?

Mr. MILLER. Yes, sir. And the whole thing would have been done away with, no doubt, if the Government didn't need the money. We are well satisfied with that.

The third one of the recommendations—and it is not recognized in the new bill—favors repeal of section 734 of the Internal Revenue Code, dealing with adjustments to be made in cases where either the taxpayer or the Commissioner maintains a position inconsistent with prior income tax determinations.

I am not going deeply into that. I have a written statement I will file, and I think it can be presented in the record about as well as orally.

The CHAIRMAN. Yes, sir; you may file it.

Mr. MILLER. I need only say that we think that that section is bad for the Government as well as for the taxpayer, because it violates the principle of repose.

Under the existing provision the taxpayer may suffer prejudice by a so-called inconsistency that may be as stale as 1913; he may suffer that prejudice through the acts of persons over whom he has no control, and never did have, and the staler the inconsistency the greater the prejudice to the taxpayer.

Another recommendation of these five has to do with carrying over the unused excess-profits tax credit for years beginning in 1940. Our position is fully shown by a short memorandum which I will file.

That leaves us nothing but the last and the most important of the association's five recommendations.

This one is our recommendation presented to you last year about this time, under which excessive hardship due to abnormalities of income or invested capital, not expressly relieved somewhere in the law, may be relieved by the Commissioner of Internal Revenue, subject to review by the United States Board of Tax Appeals. The intention of our recommendation is that such relief shall apply to all the excess-profits tax years—1940, 1941, 1942, and the following. With reference to 1940 and 1941, while those are past years, I think this is important: The larger deficiency letters are still to be issued by the Bureau of Internal Revenue, so that even 1940 and 1941, while they are past in the calendar sense, are still very open years in the process of audit, especially with regard to the difficult and substantial cases. Since 1941 calendar-year returns were not due until March 15, 1942,

and extensions were granted in many of the more difficult cases, there has not yet been time to audit many of the important ones.

We are very glad to say that the bill as passed by the House gives to the Commissioner some new powers so far as the year 1942 and subsequent years are concerned which to a certain extent can be clearly depended on to remedy the serious defect to which our recommendation was addressed, but the bill does not, as it should, cover 1940 and 1941 now in process of audit.

It is also true that the provision contains some limiting phrases which might be construed as depriving the Commissioner of power to relieve, even as to 1942 taxes, certain cases which will need relief and which would have been relievable under the corresponding relief provisions of the 1917, 1918, and 1921 laws found in the statute books.

On the whole, considering the immense difficulties presented by this problem of general relief, we certainly appreciate the work done by the Ways and Means Committee, the joint committee, and the Treasury.

Without promising to agree with all that has been done, we should like to express our thanks for their constructive labors in dealing with this very difficult and certainly controversial phase of the tax law.

The definite suggestions that we make on this subject of general relief are two:

First, we strongly urge that the provisions of the existing bill be made to apply to those 2 years 1940 and 1941 which are still really to be fought out, so that the whole excess profits period will be governed by the same procedures.

Second, I want to mention in detail a few types of cases in which the terms of this bill, as passed by the House, might be construed as denying the Commissioner power to relieve in certain cases, even if he should consider that relief needs to be given.

First, as to the need of having this made to apply to 1940 and 1941. Suppose a taxpayer that wasn't in existence during the base period, organized brand new, with no supplement A background, on January 15, 1940. Being organized after the end of the base period the present law gives it no right to use base period income credit. Any credit it gets must be based on invested capital.

Now suppose that the business of the taxpayer is such that the invested capital provisions are wholly inapt. The current bill gives a list of situations in which the invested capital credit is inapt:

One of them, for instance, is that intangible assets—and I am quoting from this bill—"not includible in invested capital under section 718 make important contributions to income," or that "capital is not an important income-producing factor," and there is a list of similar situations in the bill.

Under the bill as passed in the House relief is allowed for 1942 and subsequent years, but no relief whatever is allowed for the years 1940 and 1941, in this case.

There is no sense in that, and the defect could be easily remedied by making the relief applicable to the years 1940 and 1941.

Another example of a company that was in existence during the base period: Suppose the taxpayer is entitled to use the base period

credit, but is subjected to an excessive tax burden for 1941, because of an abnormally low base period income.

Suppose this low base period income is due to the fact that the business of the taxpayer—and I use the very language of the present bill, so far as it applies to 1942—"was depressed in the base period because of temporary economic conditions peculiar to such taxpayer, or because it was a member of an industry which was depressed on account of temporary economic circumstances peculiar to such industry"—I will skip a number of other examples that I could mention, taken out of the bill. This bill very properly authorizes the Commissioner to make these adjustments if the hardship occurs in 1942 or a later year but omits to give that relief just as badly needed for 1940 and 1941.

The CHAIRMAN. Would that be true, Mr. Miller, in the case of a corporation on a fiscal-year basis?

Mr. MILLER. It would apply to some of the fiscal-year corporations.

The CHAIRMAN. It would?

Mr. MILLER. Yes, sir.

Now, it is true, as we all know, that the excess-profits-tax rates, in the present bill and in the act that is going to result, will be higher than the rates applicable in 1940 and 1941, but it is absolutely so that the excess-profits-tax rates for those 2 years 1940 and 1941 are themselves high enough so that in particular cases they can produce hardship so great as to need relief absolutely.

The experience of the Treasury itself so far, in auditing those years, shows, as does the Treasury experience in auditing the excess-profits taxes from the first World War, that relief is needed.

The fact is the Ways and Means Committee report fully recognizes that the new higher rates merely increase rather than create the already recognized need for broader relief provisions, and I quote briefly from the report, showing that apparently the Ways and Means Committee itself recognized that this relief ought to apply to 1940 and 1941:

> The need for this legislation was recognized when the excess profits tax was enacted in 1940, and in the excess-profits-tax amendments of 1941, as pointed out in the committee reports on those acts.
>
> It was there stated that equitable considerations demand that every reasonable precaution should be taken to prevent unfair application of the excess-profits tax in abnormal cases; that high rates on excess profits are thoroughly justifiable if the income subject to tax is clearly of the type intended to be reached.
>
> The rates now proposed increase the need for expanding the application of the relief section to cases that do not fall under the specific provisions in order to remove inequities and alleviate certain hardships. The amending provisions expanding the operation of the present section 722 are based on experience gained since its enactment.

In other words the experience is that they need these provisions for 1940 and 1941, and yet, for some reason or other, they didn't apply it to those years.

To deny needed relief to a corporation suffering hardship under its 72-percent tax on the ground that it would have been in worse trouble if the tax had been 82 percent or 90 percent, certainly is not sensible nor in the Government's interest.

The fact is that the main object of these relief provisions is not just to be nice to taxpayers that are exerting pressure to be relieved.

The main object, as our committee sees it, and as experience shows, is to make the law workable as a successful producer of revenue for the Government.

Although such provisions may operate for the benefit of this or that corporate taxpayer needing relief, their most important function is to relieve the Government from the serious consequences that follow when popular opinion becomes convinced that a tax law isn't workable, or produces unconscionable results. Further, the public is going to form its opinion as to the reasonableness of the excess-profits tax law largely by observing whether these first 2 years work out sensibly or not.

It is therefore very important that the best possible relief provisions be made applicable to the 2 earlier years. A fair relief provision in those early years is, in many ways, more important than later. First impressions are undoubtedly the most important, and the Government has a stake in making people realize that this tax law is fair.

The only other point to which we desire to call attention, for such action as your committee may decide upon, is that section 722 of the bill as passed by the House contains obscurely-worded limitations which might conceivably be construed as denying relief in certain cases where the Government's broader interest requires giving relief. I give one illustration of that:

A corporation may suffer undue hardship in the year 1942, because it happens to be one of those corporations enumerated in section 722 (c) of this bill, whose situation is such that the invested capital credit is inapt.

Further, we will say, this corporation changed its business on January 31, 1940. It changed it from snuff making to cigar making, an illustration already used in the report of the Ways and Means Committee.

Suppose it couldn't make any money at snuff and it could make profits at cigar making, and it made the change, not because of the war or anything to do with the war. It was just a sensible and ordinary moving over from a poor line of business to a good one.

Clearly, the technical base period can't give any relief at all, because, during the base period it was engaged in a different business in which it didn't make any money.

We find that this bill, in section 722, subdivision (b), has an express provision which would have given relief to that corporation if the change had occurred a month earlier, that is, during or immediately prior to the base period.

But there are no specific provisions as to changes after December 31, 1939. This corporation is just 31 days too late to come within that express provision.

To give relief in a case of this kind, where the Commissioner felt it ought to be given, the only subparagraph which is not clearly limited to this base period time is subparagraph 5.

But that subparagraph 5, after providing that the Commissioner may take into account any other factor affecting the taxpayer's business, which may reasonably be construed as resulting in an inadequate standard of normal earnings during the base period adds a vague limitation and its vagueness is all the more important, be-

cause there isn't any review of this by the courts. That limitation requires—

> the application of this section must not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein.

Of course this raises the question: What are the "principles underlying?" They are not anywhere specifically stated.

There are just five directly stated subparagraphs there, with no suggestion as to a "principle," and it is hard to tell what that limitation is.

Now, further, in order to get relief for this obviously deserving case, one would have to construe also subdivision (a) of section 722, the last sentence of it. I will read that:

> In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939.

There is a problem there as to just how much that limitation tends to prevent relief in such a case as I have given, where a change happened after December 31, 1939. If the Commissioner and the Board should by any chance feel bound to hold that these limitations deny the Commissioner power to relieve undue hardship in such a case as the one I have stated, it is clear that the relief provided by the section is available in fewer cases than the relief afforded by the Revenue Acts of 1917, 1918, or 1921, and found useful to the Government in administering those acts.

That is all we desire to say, except this: Notwithstanding these difficulties that I have just mentioned, it ought also to be said that the clearer parts of the relief provisions of the bill are such that very many types of meritorious cases not relievable under existing law could be very successfully dealt with by the tax authorities under section 722 as it is now in the bill if that is enacted. It at least goes a very considerable way toward curing the defects at which our recommendation was directed.

Thank you, sir.

The CHAIRMAN. Thank you, very much, Mr. Miller.

Mr. Miller, do you suggest any amendments?

Mr. MILLER. We have no specific suggestions. The criticisms that we have made hardly need drafting. They can so simply be changed.

The CHAIRMAN. I thought perhaps you had drafted some specific amendments.

Mr. MILLER. It would be so easy merely to provide for 1941 and 1940.

Senator CONNALLY. Would that apply to cases already settled?

Mr. MILLER. The cases which have already been settled, if it were made simply retroactive? It would depend somewhat on the phrasing of the words applying to 1940 and 1941.

I would say that if nothing were said except that this relief provision shall be effective for years beginning after December 31, 1939, it would have practically no effect on those closed cases.

Speaking for myself rather than for the association, I think the important cases, needing relief for 1940 and 1941, are not the closed ones, but those which the Government itself stirs up in the future, by issuing deficiency letters. If any such question came up as to the

retroactive character of it, I personally would think it sensible not to draw this so as to give rise to refunds with reference to 1940 and 1941.

Senator CONNALLY. I was wondering whether it would automatically result in reopening cases for further adjustment when they had already been settled.

Mr. MILLER. I think it could be so drawn as not to do that, and I don't think the Bar Associaton would feel that its recommendation had been flouted if that result were avoided in the drafting.

The main thing is the handling of the cases where the Government still, in the future, issues a deficiency letter asking for more money with respect to 1940 or 1941.

Senator WALSH. Did I understand you to say that the Government had issued no deficiency letters in 1939 and 1940 cases?

Mr. MILLER. The Government undoubtedly has issued a great many deficiency letters for 1940, but the problem of auditing a certain year is peculiar, in that you have a great flock of little no-account cases and of medium-sized cases, and a relatively few important and difficult cases, involving substantial sums. My impression of the facts there is that the Government has made very good progress, as fas as numbers of cases audited go, but that for the most part the deficiency letters in the real tough nuts are still to be worked out, and those are the ones that cause trouble.

The CHAIRMAN. All right. Thank you very much, Mr. Miller.

(Mr. Miller submitted the following supplementary statement:)

ADDITIONAL STATEMENT BY ROBERT N. MILLER, WASHINGTON, D. C., CHAIRMAN OF EXCESS PROFITS TAX COMMITTEE, TAXATION SECTION, AMERICAN BAR ASSOCIATION

A. CARRY-OVER OF EXCESS PROFITS TAX CREDIT

The association recommends to the Congress that the provisions as to carrying over the unused excess-profits credit for years beginning in 1940 be restored as such provisions were, prior to the recently enacted Revenue Act of 1941, and to this end recommends repeal of section 202 (c) of that act (adding to sec. 710 (c) (1) of the Internal Revenue Code the following sentence: "For such purpose the excess-profits credit and the excess-profits net income for any taxable year beginning in 1940 shall be computed under the law applicable to taxable years beginning in 1941.")

Reasons.—Section 710 (c), Internal Revenue Code, has been properly regarded as an important element in easing the strain on new businesses or on businesses in which the income is variable from year to year. Its effect was that a corporation which had a larger excess-profits credit for 1940 than it could use, would be permitted to carry over that credit to 1941; if still unused, to 1942.

Section 202 (c) of the Revenue Act of 1941 has the effect of denying, to a substantial extent, that carry-over. In effect it reduces the carry-over by an amount equal to the normal income taxes paid by the corporation for 1940. For example, suppose a corporation, under the Revenue Act of 1940, has an unused excess-profits tax credit of $50,000 (obtained by computing the difference between an excess-profits credit of $500,000 and an excess-profits net income of $450,000, which it wipes out). Under the Revenue Act of 1940, this could be carried over to increase the excess-profits-tax credit available for 1941, or, under certain circumstances, for 1942. Suppose one of the adjustments used under section 711 in computing the excess-profits net income for 1940 involved 1940 income taxes of $60,000; the effect of section 202 (c) is to increase the excess-profits net income for 1940, for no other purpose than the computation of 1941 taxes, by this sum of $60,000. The ultimate effect is to cut the carry-over down by that amount; on these figures there would be no carry-over.

Section 202 (c) does this by amending section 710 (c) (1) of the Internal Revenue Code, so that for the purpose of the carry-over but not for the purpose

of determining the tax liability for 1940, ("the excess-profits net income for any taxable year beginning in 1940 shall be computed under the law applicable to taxable years beginning in 1941."

Taxpayers who computed their excess-profit tax liability for the year 1940 did so on the reasonable assumption that the method of computing the excess-profits net income for 1940 would not be changed after March *5, 1941, the date on which calendar year corporations were required to file their 1940 returns.

A business entitled to a carry-over would be negligent if it did not take the carry-over into account in business operations. For instance, decisions during 1940 whether to hold or clear out a large inventory would naturally be influenced by the availability of a resulting loss. To be sure, a business would have to take into account the possibility that the whole principle of carry-over might be repealed, as regards 1941, but it does not seem good policy on the part of the Government to go out of its way, in September 1941, merely to change the method of computing the 1940 carry-over in such a way as to cut down the amount of it.

One reason why many taxpayers were reasonably content not to oppose enactment of the Revenue Act of 1940 was that it provided for this carry-over; to pass the bill on the basis of the carry-over and then to substantial extent withdraw the carry-over retroactively does not seem to be fair dealing.

As we have often pointed out, a Government needs the good will of its taxpayers just as a department store needs the goodwill of its customers; provisions like this, which tend to give the taxpayer an impression that the Federal Government is unreliable, are contrary to the interests of the tax system.

In considering this recommendation it should be borne in mind that the new provision results in no increase in 1940 tax, and that in the computation under the new provision there is a mitigating increase in base period income, since income taxes are no longer a deduction in the determination of that income.

B. ADJUSTMENT IN CASES OF INCONSISTENCIES

The association recommends repeal of the present section 734, Internal Revenue Code, entitled "Adjustment in case of position inconsistent with prior income-tax liability."

Reasons.—The Treasury Department issued on January 26, 1942, Treasury Decision No. 5112, amending sections 30.734-1 and 30.734-2 of Regulations 109. The issuance of this Treasury decision has been helpful in removing some important difficulties connected with section 734. The following discussion, giving the association's reasons why the continuance of section 734 is not in the interest of the United States, deals only with difficulties which have not been removed by the issuance of the Treasury decision.

The general effect of section 734 is that if in determining the excess-profits tax an item affecting the invested capital credit is treated (for purposes of the current excess-profits tax) in a manner "inconsistent with the treatment accorded such item in determining income-tax liability of the taxpayer or a predecessor of the taxpayer for a prior taxable year," and if the tax for such prior taxable year would be increased or decreased if computed in a manner consistent with the current determination, and if on the date of the determination of the excess-profits tax it is too late to change the liability for the earlier year, then adjustment of the current excess-profits tax is to be made under this section, as follows: If additional tax is indicated for the earlier year, the amount of such tax is computed, interest is added thereto for the whole intervening period, and the total is to be added to the current excess-profits tax otherwise computed.

The section provides that this adjustment shall be made "only if there is adopted * * * a position maintained by the Commissioner (in case the net effect of the adjustment would be a decrease in the income taxes previously determined for such year or years) or by the taxpayer with respect to whom the determination is made (in case the net effect of the adjustment would be an increase in the income taxes previously determined for such year or years) which position is inconsistent," etc.

To show how the section works in a case where the Commissioner invokes the section, suppose the taxpayer corporation took part, in 1918, in a transaction in which a number of individual "predecessors" conveyed certain corporate stocks to the corporation in exchange for stock of the corporation. The various transferors realized a million dollars of income in the transaction, but reported no

income for taxation because it was generally believed at that time—erroneously, as rulings go now—that no such action was required under the provisions of the law and regulations concerning "nonrecognizing" transactions. The Government, sharing the taxpayers' view of the law, permitted the statute of limitations to bar it from collecting from the individuals. In computing its invested capital credit for the year 1940, the corporation finds that its equity invested capital under section 718 of the Internal Revenue Code should include the million dollars, because under present interpretations of law the transaction was taxable, and it files its excess-profits tax return on that basis, wholly correct under section 718 which defines invested capital.

Upon the audit, the Commissioner admits that the computation of the invested-capital credit is correct and that the tax is computed correctly, but invokes section 734, saying that the predecessor individuals ought to have paid a tax for the year 1918, the view then prevailing as to the nontaxable nature of the transaction having in the interval of 22 years turned out to be wrong. Under that section, the taxpayer corporation cannot get the advantage of section 718 without being compelled to increase the tax shown to be due in respect of the year 1940 by an amount equivalent to what the predecessor individuals should have paid in respect to the year 1918, plus interest for 22 years at the rate of 6 percent. To compute this the taxpayer would have to know what tax brackets were applicable to the various individuals whose 1918 tax returns were involved and all the facts as to the various items of income and deductions, as to each of those individuals.

The taxpayer corporation, under the recent Treasury decision, is afforded the right, if it so chooses, to avoid the additions based on the 1918 computations by electing to give up, in computing the 1940 tax, the million dollars of invested capital to which it is entitled under section 718, of the code as added by the 1940 law, but the provision is unwise in the first place in that it violates the principle of repose, which has been found wise in centuries of legal experience. The Government, having allowed 22 years to go by, should not use its legislative power to resuscitate its own dead claim.

The taxpayer is thus placed at a serious tax disadvantage as compared with its competitors merely because of a circumstance which occurred 22 years before, and because of the conduct of people over whose conduct the taxpayer never had any control. It will be noted that the tax burden for 1918 would have been borne by the individuals, and that the amount of the tax would have been determined by various circumstances such as the amount of income, the amount of losses and other deductions, etc., having no connection at all with the corporation's business. The corporation is in effect denied privileges under section 718 which its competitors enjoy; and the taxpayer is thus penalized in respect of the year 1940 in a sum of money which may be very large, and which may include many years' interest.

There is no logical reason why one of two competitors should be subject to a high-rate tax because its predecessors, under a wholly different law, did something inconsistent. The provision not only violates the settled principle underlying statutes of limitation, but, because of the interest provisions arrives at the particularly distasteful result that the staler the "inconsistency" the more severe the penalty in respect to the year 1940; thus, the staler the inconsistency, the more interest appears in the addition to the 1940 tax; in the case above stated, the interest alone amounts to 132 percent. There will, of course, be many cases in which the predecessors were not relying on current practices, but even in those cases there is no reason for discriminating in 1940 between competitors merely because of an inconsistency many years old.

Other features of this peculiar provision are summarized below:

(1) *Lack of relation to general theory of the present excess-profits tax.*—This provision contemplates, in effect, an addition to a corporation's excess-profits tax, which has no relation at all to the general theory on which the present excess-profits tax is based.

(2) *Lack of relation to general policy of revenue system.*—The provision is out of line with the general policy of our whole revenue system. Under this system, ordinarily, the Commissioner is required by law to impose the excess-profits tax in accordance with the statute, without respect to the Commissioner's inclinations or to the taxpayer's inclinations. But under this provision the taxpayer's liability for the year 1940 may, obviously, depend in certain cases on whether or not the Commissioner decided to "maintain" a certain position, or, on the other hand, on whether or not the taxpayer "maintains" a certain position.

Such a deviation from general principles of tax administration is bound to cause unnecessary administrative difficulties.

(3) *Taxpayer prejudiced by predecessor's action over which it had no control and about which it might have no information.*—The action of predecessors in the case above referred to is what really subjects the taxpayer corporation to a competitive disadvantage in computing its excess-profits tax. This is not fair—the taxpayer never had any control over their actions, nor does the law afford the taxpayer any access to any returns which they may have filed in the Bureau of Internal Revenue. The taxpayer has no sure way of finding out the facts, having no legal access to them and being handicapped by the fact that the records of individuals are often hard to trace because of careless methods and of deaths, removals, and casualties. Thus, if the Government makes a "holding" that certain facts existed with respect to the tax liability of the predecessors for the year 1918, presumption in favor of the correctness of the Government's holding puts upon the taxpayer the often impossible burden of disproving the Commissioner's finding.

(4) *Provision is unnecessary if inconsistency involves any fraudulent intent.*—Where the predecessor was guilty of fraudulent concealment or fraudulent failure to report the proper amount of net income in 1918 or whatever earlier year is involved, the Government has now and has always had the privilege of going back and making correction without any restraint from a statute of limitations, because fraud cases are not subject to the statute of limitations. In other words, if there was bad faith in the earlier year, the Government has the right, without section 734, to go back and collect the tax and interest from the proper taxpayers, if it can find them. Therefore, there is no need of this provision if the inconsistency involves any fraudulent intent.

(5) *In many cases inconsistency is due to Government's earlier error, rather than taxpayer's.*—The question whether, under peculiar circumstances of sale or exchange, taxable income is realized and is to be recognized has been one as to which Government rulings have frequently changed and as to which experts may well differ. In a great many cases the failure of predecessors in earlier years, or of the corporation itself, to take the position which has later come to be recognized as the proper one, is due to the fact that the Government at that time was taking a different position from its present position—in some cases because the law was different than from what it is now, and in other cases merely because the Government was wrong as proved by the later decisions of courts. In effect, therefore, the advance result of the application of section 734 to a particular taxpayer as compared with competitors which are permitted to follow the provisions of section 718 in computing their invested-capital credit is due in many instances merely to the fact that the history of its invested capital involves a question as to which the Government was uncertain many years before.

(6) *Method inapplicable where determination in earlier years represented lump-sum compromise of many issues rather than individual adjudication of each.*—Since corporations must of necessity treat taxes as a practical matter of dollars to be paid, determination of a corporation's net tax liability for any year—for instance, one of the earlier years as to which an inconsistency is claimed—the chances are quite strong that when the taxpayer and the Government were discussing the determination for such earlier year the corporation did not treat each of the many issues involved as a separate issue to be fought to a conclusion on its merits, but instead continued its negotiations with the Government only until the total amount of tax demanded for the year involved was brought down to an amount in dollars which the corporation was willing to pay. In other words, the ordinary method of settling a tax controversy, involving perhaps a hundred or more identical points, does not involve a continued controversy as to each of the points, but, rather, a give-and-take dealing with the whole case. The predecessor, or the corporation, if the early settlement was made by it, was primarily interested in the number of dollars it had to pay; once the net determination was reduced to an acceptable dollar figure, the taxpayer, in general, lost interest in the method by which the Government reached the net result. In any case where the dollar result has been agreed upon with the taxpayer, the natural tendency of the Government auditors is to write up the case on whatever basis, as regards the various items involved, will involve the least controversy in the review process. Thus the "inconsistency" may be really an illusory one.

There is grave question, therefore, whether any provision based on the assumption that in a complicated case each one of the various doubtful points has been argued out and decided separately on its merits, can be successfully administered; such a conception of the settlement of important cases does not

square with the everyday administrative process which must be followed by the Bureau if there is to be a reasonably prompt disposition of tax disputes with a minimum of litigation.

(7) *As between the benefits of theoretical consistency and the disadvantage of upsetting long-settled controversies, the enforcement of consistency is the less important.*—Practical experience has long demonstrated that the theoretical advantage of consistency is often far outweighed by the practical advantage of a statute of repose. Every statute of limitations is a recognition of this; so is the principle of res adjudicata. The principle of public policy which underlies all limitation statutes is based, obviously, on the fact that as time passes witnesses die or become unavailable, records have been lost or destroyed, and human memories become unreliable. Section 734 makes very large amounts of current tax, under a new law, depend on "determinations" made years ago.

The overemphasis on "consistency" seems to be illustrated by the fact that under this provision a taxpayer may have to suffer severely for acts committed long ago by its "predecessor" (the word "predecessor" is now defined in T. D. 5112). When one remembers the fact that the Government itself has destroyed many of its earlier tax files, and that even when those files are still available to the Government, provisions of law render some of them inaccessible to a successor corporation, the unfair practical effects are clear.

STATEMENT OF H. CECIL KILPATRICK, WASHINGTON, D. C., CHAIRMAN, FEDERAL ESTATE AND GIFT TAX COMMITTEE, TAX SECTION, AMERICAN BAR ASSOCIATION

The CHAIRMAN. Mr. Kilpatrick.

Mr. KILPATRICK. Mr. Chairman, I am chairman of the Federal estate and gift tax committee of the American Bar Association's tax section, and I address myself only to matters relating to estate and gift taxes.

We made several recommendations at our appearance before the Ways and Means Committee, some of which have been adopted, and I shall not take this committee's time in discussing those recommendations.

Of the other recommendations, the first has to do with the simplification of the rate schedules for the estate tax.

I can probably state the situation better by using the language that the Ways and Means Committee itself used in its report on the 1938 act.

The committee said there:

> The basic estate tax imposed by the 1926 act has been supplemented by the additional estate tax imposed by the 1932 act as amended. These two taxes—the basic estate tax and the additional estate tax—differ in many respects: Namely in their rates, in the amount of the specific exemption allowed, in the credit provisions, and in the value of the gross estate requiring the filing of a return.
>
> These differences have occasioned much complexity in the determination and computation of the estate tax.

Now, in 1938 the Ways and Means Committee proposed to simplify the bill by providing a single rate schedule with a credit for State death taxes at a flat rate of 16½ percent. As the members of this committee well know, the reason for the two rate schedules is that the credit allowed for State death taxes is limited to 80 percent of the basic estate tax under the 1926 act.

You get no credit against your additional estate taxes.

Senator GERRY. Isn't what you are getting at there: That up to the 1926 act the States got a credit and since that 1926 act you haven't had the credit?

Mr. KILPATRICK. They do get a credit now, sir, but it is limited to 80 percent of the rates prescribed by the 1926 act.

Senator GERRY. That is what I am referring to. In other words, you simply continued what was in the 1926 act, and none of these subsequent acts have made any change, have they on that rate?

Mr. KILPATRICK. That is what we call the basic estate taxes—the 1926 rate—and the credit for State death taxes is 80 percent of the tax computed under that law.

Of course, your Federal estate tax is made up of that, and your additional estate taxes.

Senator GERRY. Your subsequent additions that were made to the estate tax get no credit?

Mr. KILPATRICK. No, sir.

Senator GERRY. That is what you are referring to?

Mr. KILPATRICK. Yes, sir.

We are not complaining of that at all, and our recommendation will not change the tax liability at all.

Senator GERRY. What you are suggesting is a combined rate of the two?

Mr. KILPATRICK. Yes, sir; with a graduated credit computation which will produce exactly the same result as existing law.

Senator GERRY. Yes; but when you do that you are getting into a different percentage basis. What you are doing is trying to average that, aren't you?

Mr. KILPATRICK. No, sir. What we did—and we have submitted to the staff of the Joint Committee on Internal Revenue Taxation and to the Ways and Means Committee a proposed amendment to reach it, and I have also talked with the draftsmen in the Treasury Department about it, and they stated to me informally that they believed the scheme which we had evolved would make no change whatever in the amount of credit for State death taxes.

Senator GERRY. They have had that proposition up in the committee, I know, because I have talked to some of the experts, and there is a percentage question. Have you got your amendment there?

Mr. KILPATRICK. Yes, sir.

This document which I have is considerably out of date, because it has a great many things in it that the House draft has taken care of.

Senator WALSH. Are your recommendations in the interests of simplicity?

Mr. KILPATRICK. Simply in the interests of simplicity. It would not change the amount of revenue one nickel.

Senator GERRY. There is a question, though, of how it would affect different estate rates in the amount of the tax. It isn't as simple as all that.

Mr. KILPATRICK. I think what you have in mind is this: When the House made its proposal of a flat rate of a 16⅔ percent credit, the State of New York and some of the other States came in and said, "Our State laws are geared to your 80 percent credit, and if you apply this we are going to lose money," and that was the reason the 16⅔ percent flat credit was rejected.

Senator GERRY. I think there are some more questions involved in that.

Mr. KIRKPATRICK. I am sorry I don't know what they are, sir, because we are fairly confident that the adoption of the graduated scale proposed by us would not affect the State's revenues at all.

Our second recommendation deals with a subject on which the House bill has taken some action, but with which we do not entirely agree: that is, the inclusion of life insurance proceeds in the taxable estate.

Since the 1918 act the law has provided for the inclusion of these proceeds in the case of policies to named beneficiaries—that is, over and beyond the specified exemption—under policies, the statute said, taken out by the decedent on his own life.

Now, that phrase "taken out by the decedent on his own life" has had four separate and inconsistent interpretations by the Treasury Department, and the Board of Tax Appeals and court decisions have been conflicting and confusing on just what insurance should be included and what should not.

The Treasury recognized the need for clarification, and they recommended to the House that that provision be clarified.

Their recommendation was adopted. The House bill provides that these proceeds are includible if either of two conditions exist: (1) If the decedent paid the premiums, or (2) if at the time of his death he had any property rights—what are called incidents of ownership—in the policy; that is, the right to borrow, turn it in for its cash value, the right to change the beneficiary.

Now, we are in entire agreement that that second test should be the test.

We do not believe that the test of payment of premiums alone should be, and we say that for two reasons: (1) That the estate tax is, in theory, a tax on the transfer of property by testamentary disposition, and if the decedent had no property rights, no control over the economic benefits of a policy, there was not actually a transfer resulting from his death, a transfer from the dead to the living; and (2) that that will lead to litigation, because the Supreme Court, by way of dictum, in the case of *Llewellyn* v. *Frick* (268 U. S.), indicated that the test of premium payments alone would be an invalid and unconstitutional test.

Senator GERRY. Will you put your amendment in? Have you got your amendment?

Mr. KILPATRICK. Yes, sir; I will hand it in right now.

Senator GERRY. Will you put it in with your remarks?

Mr. KILPATRICK. Yes, sir.

Senator GERRY. So we can see just what it is.

Mr. KILPATRICK. Would you prefer that I have that typed up and file it with the clerk, rather than present this whole document which covers other fields?

Senator GUFFEY. We don't want the whole document—just the amendment.

Mr. KILPATRICK. I will give it to the reporter.

Senator GERRY. When did you first suggest this amendment?

Mr. KILPATRICK. It was first presented to the Ways and Means Committee on this present bill.

Senator GERRY. So it is a new amendment?

Mr. KILPATRICK. Yes, sir; it is a new amendment. I had discussed it informally with members of the Joint Committee staff before we actually presented it.

I don't mean to say that it had their approval. I mean they had given it a friendly hearing anyway.

Senator WALSH. I don't think you finished the statement about the insurance, had you?

Mr. KILPATRICK. I believe I had. The only test, I think, that should be made, is the test of whether the decedent had any of the incidents of ownership, and we are satisfied with the House's definition of that term "incidents of ownership."

The CHAIRMAN. You think the provision regarding the payment of premiums should be eliminated?

Mr. KILPATRICK. Yes, sir.

The CHAIRMAN. For the sake of clarity and simplicity, and in order to avoid those questions arising?

Mr. KILPATRICK. The question of constitutionality arising.

The CHAIRMAN. All right, Mr. Kilpatrick.

Mr. KILPATRICK. We have only one other point that I wanted to call to the committee's attention.

This has to do with the credit allowed against the estate tax for gift taxes paid during the decedent's life.

The gift tax, in theory—or in part, at least—was designed to prevent avoidance of estate taxes through a man being able to give away, when he was approaching death, a large part of his property which would come in the higher brackets of the estate tax.

However, there are numerous gifts which are taxable, but the proceeds of which are includible in the estate for estate tax purposes—and I refer there not only to gifts in contemplation of death—but, if I buy a house with my money and take it in jointly with my wife in a tenancy by the entirety, or if I give a tenancy by the entirety, the entire value of that property is included in my estate.

Now, the theory of the law is that, when that happens, the property having paid a gift tax, there should be a credit on account of that, since it is now being subjected to the estate taxes.

In practice, however, the way that is worked out under the formula provided by the law, you don't get a credit for all of the gift tax paid; you only get a percentage of it which will depend upon the value—the ratio, I should say—of the value of the property given away to the rest of the estate, and the result is that very often the gift and estate taxes, after this credit, amount to substantially more than the estate tax would have been had the man continued to own the property until his death.

We feel that the credits in a case of that sort should be the entire gift tax paid on property which is includible in the estate, so that the Government will wind up collecting the same amount of estate taxes that it would—the same amount of total taxes, estate and gift—that it would if the ownership had continued in the decedent until the time of his death.

That is the theory, as I understand it, of the gift-tax credit, but in practice, because of that limitation, the estate doesn't get the benefit.

That concludes our recommendations.
The CHAIRMAN. Thank you very much, Mr. Kilpatrick.
(Mr. Kilpatrick submitted the following:)

ESTATE AND GIFT TAX RECOMMENDATIONS

Applicable to Internal Revenue Code, subtitle A, chapter 3

I. SIMPLIFICATION OF RATE SCHEDULES FOR ESTATE TAX AND CREDITS FOR GIFT AND STATE INHERITANCE TAXES

The Association recommends that the schedule of estate tax rates and the provisions for credit for gift taxes and credit for estate, succession, legacy, and inheritances taxes paid the states be simplified. The Association proposes that this result be achieved by changing the indicated sections of the Internal Revenue Code as follows: by amending section 810 to set forth a single schedule of rates and repealing section 935; by amending section 813 to make a single provision for credits for gift taxes, and repealing section 936 (b); by amending section 813 (b) to provide the credit for estate, succession, legacy, and inheritance taxes paid to the states, and repealing section 936 (a), all without any change in the amount of estate taxes or credits against such taxes. To this end the following changes are suggested (new wording is italicized in each case):

Amend section 810 to read:

"Section 810. Rate of Tax.

"A tax equal to the sum of the following percentages of the value of the net estate (determined as provided in section 812) shall be imposed on the transfer of the net estate of every decedent, citizen or resident of the United States, dying after the enactment of this title.

"Upon net estates not in excess of $10,000, 2 per centum; $200 upon net estates of $10,000 and upon net estates in excess of $10,000 and not in excess of $20,000, 4 per centum in addition of such excess;

(continue schedule of rates exactly as now provided in section 935 (b)).

Amend section 812 to read:

"Section 812. Net Estate.

"For the purpose of the tax the value of the net estate shall be determined in the case of a citizen or resident of the United States, by deducting from the value of the gross estate—

"(a) Exemption.—An exemption of $40,000; * * *"

Amend section 813 to read:

"Section 813. Credits Against Tax.

"(a) Gift Tax.—(1) If a tax has been *paid under chapter 4 or under Title III of the Revenue Act of 1932, 47 Stat. 245, or* under section 319 of the Revenue Act of 1924, 43 Stat. 313, as amended by section 324 of the Revenue Act of 1926, 44 Stat. 86, on a gift, and thereafter upon the death of the donor any amount *in respect of such gift* is required to be included *in the value of* the gross estate of the decedent *for the purposes of chapter 3*, then there shall be credited against *the tax imposed by section 810 or 860 the* amount *of the* tax paid *under chapter 4 or under Title III of the Revenue Act of 1932, 47 Stat. 245, or under section 319 of the Revenue Act of 1924, 43 Stat. 313, as amended by section 324 of the Revenue Act of 1926, 44 Stat. 86, with respect to so much of the property which constituted the gift as is included in the gross estate, except that the amount of such credit shall not exceed an amount which bears the same ratio to the tax imposed by section 810 or 860 as the value (at the time of the gift or at the time of the death, whichever is lower) and so much of the property which constituted the gift as is included in the gross estate, bears to the value of the gross estate.*

"(2) *For the purpose of paragraph (1), the amount of tax paid for any year under chapter 4 or under Title III of the Revenue Act of 1932, 47 Stat. 245, or under section 319 of the Revenue Act of 1924, 43 Stat. 313, as amended by section 324 of the Revenue Act of 1926, 44 Stat. 86, with respect to any property shall be an amount which bears the same ratio to the total tax paid for such year as the value of such property bears to the total amount of net gifts (computed without deduction of the specific exemption) for such year.*

"(b) *Estate, Succession, Legacy and Inheritance Taxes.*—

"(1) The tax imposed by section 810 or 860 shall be credited with the amount of any estate, inheritance, legacy or succession taxes actually paid to any State or Territory or the District of Columbia, or any possession of the United States, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent).

"(2) *The credit allowed by this subsection shall not exceed the following amounts:*

"If the estate does not exceed $110,000, eight-tenths of 1 percent of the amount by which the net estate exceeds $60,000;

"If the net estate exceeds $110,000 and does not exceed $160,000, $800 plus 1.6 percent in addition of the excess over $110,000;

"If the net estate exceeds $160,000 and does not exceed $260,000, $1,200 plus 2.4 percent in addition of the excess over $160,000;

(continue this, using the brackets in the 1926 act and 80 percent of the 1926 rates).

"If the net estate exceeds $10,060,000, $1,068,400 plus 16 percent in addition of the excess over $10,060,000.

"(3) The credit allowed by this subsection shall include only such taxes as were actually paid and credit therefor claimed within four years after the filing of the return required by section 821 or section 864, except that—

"(A) If a petition for redetermination of a deficiency has been filed with the Board of Tax Appeals within the time prescribed in section 871, then within such 4-year period or before the expiration of 60 days after the decision of the Board becomes final.

"(B) If under section 822 (a) (2) or section 871 (b), an extension of time has been granted for payment of tax shown on the return or of a deficiency then within such four-year period or before the date of the expiration of the period of the extension.

"Refund based on the credit made (despite the provisions of sections 910 to 912, inclusive), shall be made if claim therefor is filed within the period above provided. Any such refund shall be made without interest."

Repeal sections 935, 936, and 937.

Explanation:

The proposal is designed to simplify the rate schedules of the federal estate tax by combining the present schedules of rates and by revising the provisions as to credits. The proposed amendments would make no change in the amount of tax due the United States nor would they make any change in the amount of the credit for state inheritance taxes. This is in line with the proposal of the Ways and Means Committee, embodied in sections 501 and 502 of the 1938 revenue bill (H. R. 9682, 75th Cong., 3d sess.), but which was stricken out by the Senate and the conferees.[1]

Many of the state inheritance tax laws are geared to the existing Federal law, in order to make the state tax equal exactly the maximum credit.

The present proposal is designed to meet the objection of the state taxing authorities that the proposal in the 1938 bill would reduce state revenues. This would be accomplished by using a *graduated* credit table. A study of state laws indicates that the proposal will not affect the results under present law as to: (a) the amount of Federal estate taxes, (b) the amount of the credit for state inheritance taxes, or (c) the revenues of 39 of the state jurisdictions under their existing laws.

The proposal would necessitate amendment of state laws in 14 jurisdictions,[2]

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[1] The need for such provisions was stated in the committee's report on the 1938 revenue bill (H. R. Rep. 1860, p. 58):

"The basic estate tax imposed by section 201 (a) of the Revenue Act of 1926 has been supplemented by the additional estate tax imposed by section 401 of the Revenue Act of 1932, as amended. These two taxes, the basic estate tax and the additional estate tax, differ in many respects, namely, in their rates, in the amount of the specific exemption allowed, in the credit provisions, and in the value of the gross estate requiring the filing of a return. These differences have occasioned much complexity in the determination and computation of the estate tax. In the interest of simplicity of administration of the tax, the bill does away with the additional estate tax and substitutes its rate schedule for the original rate schedule fixed in the Revenue Act of 1926. This change will greatly lessen the complexities of determination of the estate tax."

The 1938 proposal was rejected because of opposition from State tax authorities who contended that the method proposed for computing the credit for State inheritance taxes (i. e., the allowance of a flat 10½ percent maximum credit, based on the new single rates proposed) would result in a substantial reduction of State revenues.

[2] Indiana, Kansas, Louisiana, Maine, Minnesota, Montana, Nebraska, New Hampshire, Ohio, Rhode Island, South Carolina, Texas, Vermont, and Wisconsin.

if those jurisdictions are to collect up to the full amount of the Federal credit, because their existing statutes refer specifically to the Revenue Act of 1926 and the credit provisions thereof. It hardly seems sensible, however, that the form of the Federal law should be frozen merely because the statutes of these states (which can readily be amended) were not drawn with a comprehension that future amendments of the Federal law were not only highly probable, but almost certain.

The CHAIRMAN. Mr. Fisher.

STATEMENT OF GEORGE MORRIS, WASHINGTON, D. C., CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. MORRIS. Mr. Chairman, my name is George Morris. I am from the District of Columbia, and I am the chairman of the section of taxation of the American Bar Association, of which these gentlemen who have just spoken are the chairmen of the committees.

Mr. Fisher is the chairman of the committee on income taxes. We were scheduled to appear here tomorrow morning, but to satisfy the program the clerk asked if we could get in this afternoon.

I got here, but Mr. Fisher couldn't get here.

The situation is that, with respect to the income taxes, we made seven recommendations to the Ways and Means Committee, which dealt with questions of clarification, simplification and administration and procedure.

All seven were, in whole or in part, adopted by the Ways and Means Committee, and put into the bill.

There are, however, some tag ends, some things we would like to talk over, with respect to the actual phraseology used, and if I have the chairman's permission we would prefer to present those to the staff of the Joint Committee on Internal Revenue Taxation and not take the time of the committee, because they are matters of considerable minutiae which I don't think it would profit the committee to hear.

If we may do that I have no further statement.

The CHAIRMAN. Very well. You may do that.

Mr. MORRIS. Thank you very much.

The CHAIRMAN. Mr. Fisher is not here?

Mr. MORRIS. He is not here. He will appear before the staff of the joint committee when the time is appropriate.

The CHAIRMAN. Very well. You may take it up with the staff or the Treasury.

Mr. MORRIS. Thank you.

The CHAIRMAN. Mr. Newell.

Mr. NEWELL. The point we have to bring up is a simple one and would only take a few minutes.

With your permission I would like to have it presented to the committee by the vice president of our company in charge of finance, Mr. G. V. Pach.

The CHAIRMAN. That is quite all right. Mr. Pach, you may come forward.

STATEMENT OF G. V. PACH, VICE PRESIDENT, BATH IRON WORKS CORPORATION, BATH, MAINE

Mr. PACH. This is a memorandum with respect to the base period credit for excess-profits taxes.

A long-term contractor—contracts covering a construction period of 12 months or more—has the option, for Federal income-tax purposes, of reporting his income at the time that the contract is closed out, and the profit is definitely determined, or of reporting the estimated profit annually, based on an estimate of earnings for that year—section 19.42-4, Regulations 103.

Under the regulations of the Commissioner of Internal Revenue, whichever of these two methods has been adopted can only be changed with the permission of the Commissioner. (Art. 41-2, Regulations 103.)

A taxpayer is granted certain credits to be used in calculating his excess-profits tax. These credits are based on the income of certain preceding years, namely, the 4 years 1936, 1937, 1938, and 1939, or the 2 years 1938 and 1939.

In the case of a long-term contractor who has reported his profits on a completed contract basis, his contracts may have been completed in base period or subsequent years, resulting in the reporting of profits in those years in which profits did not reflect the actual profits arising in each of the separate years.

As an example, we can take two companies, both in the same line of business and operating under the same conditions. Company A has reported its earnings on the completed contract basis, while company B had reported its earnings on the percentage of completion basis. Further, assuming that both companies have had contracts which took them approximately 3 years to complete, the average earnings basis for the two companies would be somewhat as follows:

Net earnings in—	Company A	Company B	Net earnings in—	Company A	Company B
1935		$200,000	1939		$100,000
1936		200,000	1940	$1,200,000	100,000
1937	200,000	200,000			
1938	400,000	100,000	Total	1,800,000	1,800,000

Thus while both companies have apparently earned the same profit during the years 1935 to 1940, applying the earnings to the base years 1936 to 1939, we find that company A has only an excess-profits credit of $150,000—$600,000 plus 4—while company B has an excess-profits credit of $400,000—the average earnings for 1939 and 1938.

Senator CONNALLY. Pardon me. It can take its earnings on invested capital in that event.

Mr. PACH. Assuming that they are not in either case as great as these.

Obviously the company which reported its earnings on the completed contract basis must pay a much larger tax than the company which reported on a percentage basis, although their gross earnings were identical.

This taxpayer believes that no figure other than the actual established earnings of the 4 years named in the act can properly be used to represent such earnings; if it happened that accounts were closed out during these 4 years representing earnings actually due to work done in previous years, the credit established on the basis of applying all of the earnings to the years in which the accounts happened to

have been closed out might well be far in excess of the credit to which the contractor was entitled; whereas if it happened that accounts were not closed out until years subsequent to the 4 years named for this purpose in the act, it might well happen that the credit would be far less than that due to the actual earnings of the 4 years in question. It seems entirely unfair and inequitable—both to the Government and to the contractor—to base credits on earnings that are determined by the "accident" of the year in which the accounts happened to be closed out, rather than on the actual earnings of each of the years that are required by the act to form the basis of such credit.

The report of the Senate Finance Committee on the Second Revenue Act of 1940 seems to bear out fully that the intent of the act was in agreement with the position taken above—that the actual earnings of each of the years should be used rather than arbitrary figures; any other interpretation appears contrary to reason, if not to the language.

The Senate Finance Committee, in its report on the Second Revenue Act of 1940, said:

> If it is determined that the income received in the taxable year is attributable to years in the base period, the amount of such income so attributable to such years will have the effect of increasing the base period net income and thus the credit under the average-earnings method.

Apparently the Ways and Means Committee of the House of Representatives is also desirous of preventing any unfair discrimination against any group of taxpayers, as is evidenced in their report which accompanied H. R. 7378, the revenue bill of 1942, in which the following statement appears under the caption of "General relief":

> Taxpayers may obtain relief by meeting one of the specific tests contained in section 722, but the inability to meet the specific tests will not necessarily exclude the taxpayer from the benefits of the section if it can satisfy the Commissioner or the relief court that its claim is consistent with the principles underlying the specific tests. If these are met, the tax will be determined on the basis of a constructive base period net income in lieu of the average base period net income determined under the specific provisions of subchapter E.
>
> In general, it will be necessary that the taxpayer establish—
>
> 1. That the tax computed under the specific provisions of subchapter E results in an excessive and discriminatory tax.
>
> 2. What would be a fair and just amount representing normal earnings to be used as a constructive base period net income for an excess-profits tax based upon a comparison of normal earnings and earnings during an excess-profits tax period.

In the proposed revenue bill of 1942 as reported by the Ways and Means Committee, there are several proposals intended to provide relief in certain cases where inequities would otherwise arise. However, none of those provisions furnish specific correction of the inequity which we believe exists in the case of certain long-term contractors. Rather than leave the possibilities of relief to those generalities we respectfully request remedial action to be clearly incorporated in the Revenue Act now under consideration.

This could be accomplished by a provision to the effect that the earnings of each of the base years (whose incomes determine the income credit for excess-profits tax purposes) be on the percentage of completion basis, namely, the actual earnings for such year in accordance with the progress of work advanced during the year.

Another method of correcting this situation would be to correct section 721 as follows:

(A) Section 721 (b) of the Internal Revenue Code is amended by inserting immediately after the second sentence thereof, the following:

"The amount of net abnormal income attributable to a taxable year in the base period shall be included in computing the taxpayer's average base period net income for purpose of the credit computed under section 713 in determining the tax under this subchapter for all taxable years."

(B) Section 721 (c) (1) and (2) is amended to read as follows:

"(1) The tax under this subchapter for such taxable years computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable years, and as if such portion had been included in the gross income for the taxable years to which attributable.

"(2) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year to which any portion of such net abnormal income is attributable, computed as if such net abnormal income had been included in the gross income for the taxable year to which attributable."

In addition to this specific correction, we suggest that section 722, subparagraph (b) of H. R. 7378 be changed to read as follows:

"(5) of any other factors affecting the taxpayer's business or his method of reporting income during the base period which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period and the application of this section to the taxpayer would not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein."

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. You are not sure that you would get adequate relief even under the provision as incorporated in the House bill?

Mr. PACH. We feel that it is still a little vague, and inasmuch as there were apparent directions to the collector in previous bills, that the collector is not now interpreting in the way we think they should be interpreted, we think that specific correction would be more certain.

The CHAIRMAN. It would be preferable anyway?

Mr. PACH. It would be preferable, from our standpoint; yes, sir.

The CHAIRMAN. From your point of view?

Mr. PACH. Yes, sir.

The CHAIRMAN. Thank you very much.

The CHAIRMAN. Mr. Parton is next. There were two other witnesses whose names were not on the list. I think we will have ample time to hear them. Mr. Atkinson and Mr. White, you may remain; we will hear you in just a few minutes.

All right, Mr. Parton.

STATEMENT OF GEORGE F. PARTON, NEW YORK, N. Y., PRESIDENT, NEW YORK STATE SAFE DEPOSIT ASSOCIATION; REPRESENTING THE NATIONAL SAFE DEPOSIT ADVISORY COUNCIL

Mr. PARTON. Mr. Chairman and gentlemen of the committee, my name is George F. Parton and my address is 25 Broad Street, New York City.

The CHAIRMAN. Are you having the same troubles as last year?

Mr. PARTON. They are a little different, Senator. Conditions are different today.

I am, however, still representing the National Safe Deposit Advisory Council and also the New York State Safe Deposit Association.

The CHAIRMAN. We will be glad to hear you.

Mr. PARTON. I should first apologize for not appearing yesterday as originally scheduled, but a most unusual storm dislocated all the suburban traffic, and I was unable to get to my office to complete this statement in time to get here.

I should also like to express my appreciation for the privilege of again appearing before your committee.

I am fully aware of the unprecedented conditions which are today facing the country, and I realize your stupendous task of raising, through taxation, every available dollar in order to help defray the cost of the war. The safe-deposit industry certainly wants to contribute its fair share in that effort.

Our tax problem is so relatively small compared with this whole picture that it may seem presumptuous for me to even discuss it under such unusual conditions.

Yet I believe that you are interested in all pertinent facts bearing upon any tax, however small it may be, and this alone is my justification for asking these few minutes of your valuable time.

I also believe that it is my duty to our industry, and to our 5,000,000 or so box renters, to report these facts which otherwise might be overlooked in the press of more important problems.

My purpose in appearing before you today is to present, on behalf of our industry, a plea that the present 20-percent tax rate on safe-deposit box rentals be reduced to 15 percent. This would mean a reduction of only 5 percent from the current rate and yet it would be an increase of 4 percent over that of a year ago.

I shall be very brief in presenting my reasons for this request.

I have prepared a summary of some figures which I recently assembled from a group of 165 safe-deposit companies scattered through 27 States of the Union.

These figures have a very definite bearing upon this tax problem of ours, but as they are self-explanatory I would ask your permission, sir, to place them in the record as a part of this statement, rather than to read or discuss them in detail.

The CHAIRMAN. You may do so.

(The tabulations referred to appear in this record following Mr. Parton's statement.)

Mr. PARTON. In general, this summary reveals some very pertinent and interesting information on two separate and distinct phases of the safe deposit business over the country:

(1) The much heavier loss of old business since October 1, 1941, when our tax rate was raised to 20 percent, as compared with the same period a year ago when the rate was 11 percent.

Senator CLARK. Lots of them haven't got anything to put in a safe-deposit box.

Mr. PARTON. Well, sir, I don't know about that. The business is booming right now.

(2) A very marked and unusual increase in new box rentals in the period just prior to and since the date when we entered the war, as compared with the more normal conditions in the same period a year ago.

But the point which I should like to bring out here, and particularly emphasize, is that while the net result of the two sets of figures shows up the safe deposit business in a favorable light at the present time, upon close analysis it does not indicate a true prosperity. On the contrary, it forebodes a really serious situation which our industry will have to face when the war is over.

I appreciate, of course, that many others may be confronted with similar difficulties after the war, but our industry is so small at best, one of the smallest in fact to which any excise tax has been applied, that it is a question to what extent it could withstand a severe setback and survive with any degree of stability.

It would be most unfortunate for such a situation to confront our industry which is dedicated to the protection of people's wealth and possessions.

By way of further explanation may I draw attention to the following facts. They are not based on prediction or guesswork, and I believe them to be unassailable.

I refer first to the business already lost. My summary of figures attached to this statement shows that 165 safe deposit companies lost 5,225 more boxes since the tax rate was raised to 20 percent than during the similar period last year under the 11-percent rate.

That represents a lot of business for us, and it is by no means the total for the entire country.

There can, therefore, be no question at all that there has been this definite loss of business, and it is equally certain that it is not going to return to the safe deposit companies so long as the rate remains at 20 percent. That I believe to be self-evident.

The second point, which relates to the gain in new business, is that all of the new "war scare" rentals which have come to the safe-deposit companies in recent months—business which has resulted from one thing only, a desire for special protection against bombings and air raids—will be canceled outright immediately the war ends. That also is self-evident. This particular type of new business, which also runs into very sizable figures, is admitted to be temporary; in fact it has been placed with the safe-deposit companies on that clear understanding.

Thirdly, there are a great many hundreds of boxes that have been rented in recent months to members of the armed forces at camps and war-industry centers, and many additional boxes have been rented to men who have already left our shores on war duty. For the most part these are small boxes, but in the aggregate they form a substantial portion of this new business surge.

Many of those boxes will without a question of doubt be closed out at the first opportunity just as soon as peace is declared.

A fourth point, which constitutes a very important phase of all this new business, is the thousands of little boxes rented since the War bond drive, which are being used for the specific purpose of protecting the newly purchased bonds.

If it is reasonable in this connection to be guided by the experience of the safe-deposit companies during the last war, with the boxes rented to take care of the Liberty and Victory bonds, a very large proportion of this newly acquired business will last only until the bonds can be disposed of, following the end of the war.

And again, judging from past experience, they will be disposed of at that time and the safe deposit boxes which held them will also be given up.

So, here are at least four clear-cut reasons to show that, instead of our industry enjoying a genuine prosperity, as might be the impression gained from current reports, it will be sure to face a severe setback when this war is over, unless something can be done to forestall it.

And this should be done now, rather than later. This is my main reason for so strongly urging a reduction at this time in our tax rate.

I believe this cut in the rate would be of material benefit because, if it were granted, it would immediately react as an incentive to many people to rerent those boxes which they closed out because of the 20-percent tax. They would do that for the reason that they have regarded the 20-percent rate as unfairly high, whereas 15 percent would, I am convinced, be considered much more reasonable in relation to other excise taxes. There is abundant proof to substantiate that belief. This return of old business would in itself be an extremely important offset to the war business which we expect to see withdrawn later on and it would aid materially in providing a cushion against this anticipated period of depression in our industry that I have spoken of.

In addition to this, a reduction in our tax from the 20-percent rate, which so many prospective purchasers of War bonds have objected to, would doubtless react as an incentive for further purchases. And surely anything that can be done to help along this worthy cause should be encouraged.

A reduction in the rate to 15 percent could not, I feel sure, be considered inconsistent with prevailing conditions, for even at that rate it would still be 4 percent higher than a year ago.

Nor could it be considered a discrimination in our favor, because at 15 percent it would still be at a higher level than many of the other excise taxes.

And, lastly, such a modest reduction would not cost the Government much of anything to speak of in the way of revenue.

I fully appreciate, Mr. Chairman, that it is most unusual, to say the least, for anyone to recommend or even suggest a reduction in an existing tax rate with conditions as they are today.

This proposal of ours would, however, involve such an insignificant sacrifice in revenue, whereas it would so importantly aid an entire industry, and at the same time afford relief to many millions of taxpayers, many of whom are in the country's armed forces, that I earnestly hope it will receive your most favorable consideration.

This concludes my statement, sir, and I thank you again for the privilege of presenting it.

The CHAIRMAN. Aren't you manufacturers protected by priorities?

Mr. PARTON. We are not manufacturers, Mr. Chairman. We rent or lease safe-deposit boxes.

The CHAIRMAN. Yes; but aren't the manufacturers so protected?

Mr. PARTON. Yes; they are subject to priorities, but we have so many boxes now that are unrented that there is no demand for more boxes.

The CHAIRMAN. You have a sufficient supply available?

Mr. PARTON. The industry is only about 50 percent rented today.

The CHAIRMAN. Thank you very much.

Senator RADCLIFFE. Do you consider that this volume of temporary war-scare business—I think that is what you called it——

Mr. PARTON (interposing). Yes, sir.

Senator RADCLIFFE (continuing). Would be materially modified by the fact that the rate is 20 percent rather than 15?

You suggested that you believe that a rate of 20 percent would have a deterring effect upon the old business coming back. Do you feel also that the difference in rate between 15 and 20 would affect materially this temporary business which is coming in, from the standpoint of volume?

Mr. PARTON. I don't think the rate would have anything to do with the war-scare business.

By "war-scare business" I mean business such as depositing with the safe-deposit companies of duplicate records, from one section of the city to another for example, customers' statements of accounts, minute books, and other important documents.

I feel that the firms who do that business would do it regardless of the rate, because they are invaluable records; they must be protected.

Senator RADCLIFFE. Then your objection to the 20-percent rate, as far as that particular class of business is concerned, is that it is just intrinsically too high?

Mr. PARTON. Yes, sir.

Senator RADCLIFFE. And not that it would affect the volume of business?

Mr. PARTON. I don't think it would affect that particular type of business at all.

Senator DANAHER. Mr. Parton, I was analyzing the summary of your figures that you submitted.

As far as I can make out, the rentals over the period that the 11-percent tax is in effect, October 1, 1940, to June 30, 1941, show an increase of 1,558 rentals, and over the 20-percent tax rate incidence, from October 1, 1941, to June 30, 1942, there is an increase of 23,845 rentals.

Mr. PARTON. I think you have understated it, sir. I think the statement shows an increase of 27,412 boxes, if you look at page 2 of the summary.

Senator DANAHER. They add up to 25,403. I don't know where the difference comes.

Mr. PARTON. They check with my statement. In any case, there has been an unusual increase in business. That I frankly admit, and it is general throughout the country, but my point is that most of that business—certainly a very large proportion of it—is temporary, and that it will go out as soon as the war is over, and I am trying to provide a cushion against this situation that we will have to face.

Senator WALSH. I suppose the reason that you didn't have the record from all the States is that you have been unable to get it.

Mr. PARTON. That is correct, sir. As a matter of fact, these figures do not even include four of the largest banks in the country. I couldn't get those figures in time to bring them here. The City Bank,

the Chase Bank, the Manufacturers Trust Co., and the Corn Exchange Bank, those 4 banks themselves with 225 branches would have materially swelled these figures, but I couldn't get them in time.

Senator DANAHER. Both in losses and in gains?

Mr. PART. N. Yes, sir. The trend, however, is the same with practically every bank.

The CHAIRMAN. We thank you very much, Mr. Parton.

Mr. PARTON. Thank you, sir.

(The following tabulations were submitted by Mr. Parton for incorporation in the record:)

SUMMARY AND ANALYSIS OF SURRENDERS AND RENTALS OF SAFE DEPOSIT BOXES

[Corrected to Aug. 6, 1942]

SUMMARY OF SURRENDERS

Number of boxes surrendered during the period from Oct. 1, 1940, to June 30, 1941 (11 percent tax rate), 380 safe deposit companies reporting from 36 States 78,416

Number of boxes surrendered during period from Oct. 1, 1941, to June 30, 1942 (20 percent tax rate), 380 safe deposit companies reporting from 36 States 94,094

Net increase in number of boxes surrendered during 20 percent tax period as compared with 11 percent tax period 15,678

SUMMARY OF RENTALS

Number of boxes rented during period from Oct. 1, 1940, to June 30, 1941, 380 safe deposit companies reporting from 36 States 116,319

Number of boxes rented during period from Oct. 1, 1941, to June 30, 1942, 380 safe deposit companies reporting from 36 States 191,074

Net increase in number of boxes rented, reflecting our entry in the war .. 74,755

SURRENDERS

State	Number of safe deposit companies reporting	Oct. 1, 1940–June 30, 1941 (11-percent tax rate)	Oct. 1, 1941–June 30, 1942 (20-percent tax rate)	Increase or decrease (−)	State	Number of safe deposit companies reporting	Oct. 1, 1940–June 30, 1941 (11-percent tax rate)	Oct. 1, 1941–June 30, 1942 (20-percent tax rate)	Increase or decrease (−)
Arizona	2	338	315	−23	Ohio	8	5,007	5,866	859
California	5	982	1,166	184	Oklahoma	5	756	1,077	321
Colorado	3	641	505	−136	Oregon	12	983	1,026	43
Connecticut	25	1,381	1,671	290	Pennsylvania	62	7,117	8,495	1,378
District of Columbia	10	1,736	2,412	676	Rhode Island	1	603	684	81
Florida	2	583	645	62	South Carolina	1	44	68	24
Illinois	26	12,875	17,667	4,792	Tennessee	1	274	355	81
Indiana	2	439	531	92	Texas	2	53	83	30
Iowa	1	57	72	15	Utah	1	994	1,047	53
Kansas	6	403	446	43	Vermont	1	3	3	0
Kentucky	1	194	207	13	Virginia	2	765	840	75
Louisiana	1	93	132	39	Washington	7	1,142	1,449	307
Maine	1	102	95	−7	West Virginia	1	280	211	−69
Maryland	3	402	495	93	Wisconsin	12	5,047	5,626	579
Massachusetts	1	553	602	49	Wyoming	1	78	68	−10
Michigan	4	1,457	1,650	193	Total	.....	78,416	94,094	.....
Minnesota	17	2,231	3,732	1,501	Net increase in surrenders	.....	.....	.....	15,678
Missouri	25	4,375	4,837	462					
Nebraska	1	283	385	102					
New York	126	26,072	29,501	3,429					
North Carolina	1	73	130	67					

RENTALS

State	Number of safe deposit companies reporting	Oct. 1, 1940–June 30, 1941 (11-percent tax rate)	Oct. 1, 1941–June 30, 1942 (20-percent tax rate)	Increase or decrease (−)	State	Number of safe deposit companies reporting	Oct. 1, 1940–June 30, 1941 (11-percent tax rate)	Oct. 1, 1941–June 30, 1942 (20-percent tax rate)	Increase or decrease (−)
Arizona	2	384	836	452	North Carolina	1	113	257	144
California	5	857	1,920	1,063	Ohio	8	5,104	9,001	3,892
Colorado	3	479	883	401	Oklahoma	5	747	1,542	795
Connecticut	25	3,355	7,059	3,704	Oregon	12	1,085	3,090	2,005
District of Columbia	10	1,977	4,108	2,131	Pennsylvania	62	28,420	39,574	11,154
Florida	2	758	794	36	Rhode Island	1	517	887	370
Illinois	26	16,583	25,035	8,512	South Carolina	1	66	95	29
Indiana	2	552	908	355	Tennessee	1	358	1,032	674
Iowa	1	56	124	68	Texas	2	273	462	189
Kansas	6	653	1,043	390	Utah	1	974	2,074	1,100
Kentucky	1	198	452	254	Vermont	1	6	6	0
Louisiana	1	82	182	100	Virginia	2	893	2,347	1,454
Maine	1	86	170	84	Washington	7	1,378	3,523	2,145
Maryland	3	483	1,034	551	West Virginia	1	228	227	−1
Massachusetts	1	522	623	101	Wisconsin	12	12,140	15,768	3,622
Michigan	4	1,974	3,234	1,260	Wyoming	1	79	178	99
Minnesota	17	2,051	3,783	1,732	Total		116,319	191,074	
Missouri	25	4,072	7,398	3,326	Net increase in rentals				74,755
Nebraska	1	292	537	245					
New York	126	27,608	49,953	22,345					

The CHAIRMAN. Mr. Atkinson.

STATEMENT OF ARTHUR K. ATKINSON, VICE PRESIDENT IN CHARGE OF FINANCE, WABASH R. R. CO., ST. LOUIS, MO.

The CHAIRMAN. Will you give your name to the reporter, Mr. Atkinson?

Mr. ATKINSON. My name is Arthur K. Atkinson, and I am vice president in charge of finance, Wabash Railroad Co., with headquarters in St. Louis, Mo.

I appear for the purpose of submitting for your consideration a proposed amendment to section 1808 (e) of the Internal Revenue Code.

Beginning in October 1941, in company with other officers of the Wabash Railroad Co., we have been in informal discussions with representatives of the Treasury Department, namely Mr. John L. Sullivan, Assistant Secretary of the Treasury, and Mr. Thomas L. Tarleau the legislative counsel of the Department of the Treasury, and also the Honorable Colin F. Stam, who is chief of staff of the Joint Committee on Internal Revenue Taxation.

We have presented this proposed amendment, and in the hearings before the House Ways and Means Committee on April 1, 1941, I appeared in support of this proposed amendment.

My testimony appears on pages 1816 to 1818 of the unrevised printed record of those hearings—pages 1897 to 1901 of the revised printed record.

The House bill makes no provision with respect to this proposed amendment, although there are two amendments incorporated in that bill that have to do with the stamp tax section of the Internal Revenue Code.

Section 1808 (e) of the Internal Revenue Code, relating to stamp taxes, grants immunity in respect to the issuance, transfer, or exchange,

of securities to make effective any plan of reorganization confirmed under the provisions of section 77 of the National Bankruptcy Act.

Similar immunity is provided for in subsection (h) of section 77 of the National Bankruptcy Act.

In view of the provisions of section 1808 (e) of the Internal Revenue Code it would appear that subsection (h) of section 77 of the Bankruptcy Act is surplusage.

Attention is directed to the fact that this exemption does not apply to a railroad reorganization under the equity proceedings.

Senator CLARK. It does apply to an equity reorganization under section 77 (b)?

Mr. ATKINSON. Yes, sir. 77 (b) and 77—pertaining to railroads.

All railroad reorganizations, whether consummated in equity or under section 77 of the Bankruptcy Act are entitled to equality of treatment under the revenue laws of the United States.

Wabash Railway Co.—the predecessor of this new company Wabash Railroad Co.—went into equity receivership on December 1, 1931, more than 2 years prior to the passage of section 77 of the National Bankruptcy Act.

At the time of the passage of section 77 the Wabash receivers had already issued a substantial amount of receivers certificates, and when the possibility of transferring from equity to section 77 was considered there appeared to be serious complications; as to whether it was then possible to change the proceedings was a very doubtful question, but even if it were successfully attempted the time loss would have been serious.

The best estimate of the time required to reorganize under section 77 would be about 540 days from the filing of the petition, which, in effect, would be, for the Wabash, commencing de novo.

At the present time the Wabash reorganization is in the final stages.

The sale of the property at foreclosure sale under equity proceedings was held December 1, 1941, and at the present time we are now engaged in the distribution of the new securities. As the amount of indebtedness of the old corporation has been substantially reduced, and the income over and above the amount deductible for interest payments will be taxable at the new rates, the new company will pay a substantial Federal income tax and excess-profits tax for the year 1942, as against no payment of any Federal income taxes for the year 1941—the last year which the company was operated by the receivers.

We believe that these considerations——

Senator BROWN (interposing). How much is involved in taxes?

Mr. ATKINSON. In the stamp tax?

Senator BROWN. Yes—the Wabash Railroad.

Mr. ATKINSON. The Wabash reorganization involves an original issue tax of $150,000, and around $30,000 in transfer taxes—an aggregate of $180,000.

Our income taxes and excess-profits taxes payable this year are estimated between seven and nine million dollars.

Senator WALSH. Does the Wabash Railroad Co. have to pay that rather than the transferee?

Mr. ATKINSON. Yes, sir. We issue our securities and we pay the issuance tax, and there are certain taxes involved in the transfer of the securities from the old company to the new company.

It is proposed and respectfully recommended that section 1808–E of the Internal Revenue Code, which, as I have said, relates to stamp taxes, be amended by changing the phrase—and I quote—"or filing of conveyances" to read "or making or delivery of conveyances," which language is the language used in section 1808 (f), applicable to other corporate reorganizations under section 77 (b) of the Bankruptcy Act.

It is believed that the language of subsections (e) and (f) in this particular should be uniform, and the language now in subsection (f) is thought to be preferable.

The second part of this proposed amendment is a change in language which should follow immediately the last sentence of this section, and consists of the following: "or approved by any court of the United States in receivership proceedings in such court against a railroad corporation as defined in section 77 (m) of the National Bankruptcy Act."

The effect of that is to merely bring a railroad that is reorganized under the equity proceedings into the same category as a railroad that is reorganized in the bankruptcy court under section 77 proceedings.

If justification be needed for treating alike reorganizations under section 77 of the Bankruptcy Act and those consummated in equity proceedings, attention may be called to subsection (n) of section 77, which includes equity receivership proceedings, the same as it does the 77 cases, in granting priority to certain classes of claims.

Also, subsection (p) of section 77 imposes, in respect to solicitation of stockholders and creditors the same restriction in equity proceedings as therein provided in section 77 of the Bankruptcy Act.

Neither subsection (n) nor subsection (p) was in the original act.

Subsection (n) was amended by the act of August 11, 1939, to include equity receiverships, and subsection (p), which includes equity receiverships, was brought in, in entirety, by amendatory action of August 27, 1935.

If equity reorganizations are to be required, as in these subsections provided, to assume the burdens created by such section 77, it naturally follows as a corollary that they should be accorded its benefits and immunities. Such is the essence of equal protection under the law.

Senator CLARK. What your amendment proposes, in effect, would be simply to put the advantages of reorganization under equity procedure on the same footing with those under section 77?

Senator BROWN. Would you state briefly what objection you have to this?

Mr. ATKINSON. Everybody I have talked with agreed that it was an injustice and inadvertently overlooked. Everyone that we have talked to and discussed the problem with had that impression.

Yet we have not been able to secure the action we sought in the bill of the House Ways and Means Committee as reported out.

Senator WALSH. Are the taxes being held up?

Mr. ATKINSON. I am paying taxes under protest. I am buying stamps, I mean, to put on these things, but I have already filed a protest under it, and I hope that there is relief possible this year.

Of course, if it isn't done this year, we will probably not be able to do anything about it.

The CHAIRMAN. I wish the Treasury would make a special note of this, so that we can ask you about it later on in executive hearing.

Mr. ATKINSON. I would like to ask, if it is consistent, if I might file a short brief to supplement my remarks in the record.

The CHAIRMAN. You may do so.

Senator DANAHER. In such a memorandum, Mr. Atkinson, will you give us, if possible, the legislative history, as to why it wasn't in in the first place?

Mr. ATKINSON. I can't say why. I have heard so many say why it wasn't in and why it should go in, and so forth, that I can't say just what was the cause.

I might say that, in my reading of the reports and the history back of the Bankruptcy Act, and the amendment as incorporated in 1808 (e), that Congress had in mind to expedite these reorganizations, therefore they granted this immunity or this relief from this issuance tax, as a matter of relief, to help along these reorganizations.

Senator CLARK. Your reorganization has been a good deal more expeditious than most of those under section 77.

Mr. ATKINSON. I will leave that to you. I only know of one large road that has been organized under section 77. We are practically out, and if anybody needed the relief we needed it.

Senator CLARK. You are again becoming a large taxpayer for the first time in 8 or 10 years?

Mr. ATKINSON. Yes, sir. As I say, we are going to pay between seven and nine millions this year. We paid nothing last year.

The CHAIRMAN. Thank you very much.

(The following brief was submitted by Mr. Atkinson:)

BRIEF AMPLIFYING THE TESTIMONY OF ARTHUR K. ATKINSON, VICE PRESIDENT IN CHARGE OF FINANCE OF WABASH RAILROAD CO.

IN THE MATTER OF REVENUE REVISION OF 1942

The purpose of this brief is to bring before the Committee on Finance in concrete form the amendments proposed by Wabash Railroad Co. to section 1808 of the Internal Revenue Code.

For convenience, section 1808, subsections (e), (f), and (g) in their present form and the amendatory subsections proposed by the railroad company are set out below in parallel columns:

Section 1808 (e) of the Internal Revenue Code in its present form:	Section 1808 (e) of the Internal Revenue Code in its proposed amendatory form:
(e) REORGANIZATION OF RAILROADS ENGAGED IN INTERSTATE COMMERCE.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer(s), or exchange(s) of securities (or filing) of conveyances to make effective any plan of reorganization confirmed under the provisions of section 77 of the National Bankruptcy Act, as amended by section 1 of the act of March 3, 1933 (ch. 204, 47 Stat. 1474; U. S. C., title 11, sec. 205).	(e) REORGANIZATION OF RAILROADS UNDER NATIONAL BANKRUPTCY ACT.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities *or recking or delivery* of conveyances to make effective any plan of reorganization confirmed under the provisions of section 77 of the National Bankruptcy Act, as amended by section 1 of the act of March 3, 1933 (ch. 204, 47 Stat. 1474; U. S. C., title 11, sec. 205).

(f) CORPORATE REORGANIZATIONS.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer(s), or exchange of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under section 77B of the National Bankruptcy Act, as amended by the act of June 7, 1934 (ch. 424, 48 Stat. 919; U. S. C., title 11, sec. 207).

(f) CORPORATE REORGANIZATIONS UNDER NATIONAL BANKRUPTCY ACT.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under *chapter 10 of the National Bankruptcy Act, as amended by the act of June 22, 1938 (U. S. C., title 11, sec. 501, et seq.)*

New subsection proposed by Wabash Railroad Co.:

(g) REORGANIZATIONS IN EQUITY.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer or exchange of securities or making or delivery of conveyances on or after January 1, 1942, to make effective any plan of reorganization approved by any court of the United States in receivership proceedings in such court against a railroad corporation (as defined in section 77 (m) of the National Bankruptcy Act) or in receivership proceedings in such court against a corporation entitled to reorganization under chapter 10 of the National Bankruptcy Act, as amended by the act of June 22, 1938 (U. S. C., title 11, section 501, *et seq.*) and any moneys paid for stamps affixed subsequent to December 31, 1941, with respect to such issuance, transfer or exchange of securities, or making or delivery of conveyances, shall be refunded if a claim for refund is filed prior to March 15, 1943.

New subsection proposed in H. R. 7378:

(h) TRANSACTIONS UNDER ORDERS OF THE SECURITIES AND EXCHANGE COMMISSION.—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities, or making or delivery of conveyances, to make effective any order of the Securities and Exchange Commission as defined in section 373 (a) of chapter 1: *Provided*, That (1) the order of the Securities and Exchange Commission in obedience to which such issuance, transfer, or exchange of securities, or conveyances are made recites that such issuance, transfer, or exchange, or conveyances are necessary or appropriate to effectuate the provisions

of section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820, U. S. C., title 15, sec. 79 (b)), (2) such order specifies and itemizes the securities and other property which are ordered to be issued, transferred, exchanged, or conveyed, and (3) such issuance, transfer, or exchange, or conveyance is made in obedience to such order.

(g) CROSS REFERENCE.—For exemption in case of playing cards exported to a foreign country, see section 1830.

(l) CROSS REFERENCE.—For exemption in case of playing cards exported to a foreign country, see section 1830.

It is proposed (in this respect following the mechanics set by the House of Representatives in the text of H. R. 7378—Union Calendar No. 845) that the above amendments be brought in as part of section 507 of H R 7378, as shown by a complete amendatory section 507 annexed hereto marked "Exhibit A."

The new language incorporated in the amendatory subsections (e) and (f) is shown by italics appearing in the right-hand column. The language in the present subsections (e) and (f) which is omitted in the amended subsections (e) and (f) is shown above my parentheses in the left-hand column.

Th amendatory subsections (g) and (h) are entirely new. Subsection (g) embodies the legislation asked by Wabash Railroad and subsection (h) is a reproduction of the proposed subsection (g) in section 507 of H. R. 7378.

Certain changes in the captions of the amendatory subsections are made in the interest of brevity and uniformity and are self-explanatory.

The first change in the text is to substitute in the present subsection (e) for the words "or filing," as shown in parentheses in the above left-hand column, the words "or making or delivery" so that the incidence of the tax will be upon the making or delivery of a conveyance necessary to make a plan of reorganization effective and not upon the filing of the conveyance. This change, it will be observed, conforms the language of subsection (e) to the language of subsection (f) relating by its terms to reorganizations under section 77B and is proposed in the belief that this part of the present subsection (e) might be inoperative should the filing of a conveyance under the recording acts not be necessary to carry out the plan. In any event, the language of subsections (e) and (f) in this respect should be uniform and the language of the present subsection (f) seems more nearly to fit the case.

As the committee is aware the present subsection (f) pertains to reorganizations under section 77B, whereas section 77B is no longer in effect, having been superseded by chapter 10 of the National Bankruptcy Act as amended by the act of June 22, 1938. Accordingly, the railroad company proposes that this subsection (f) be brought up to date by substituting for the words "section 77B of the National Bankruptcy Act, as amended by the act of June 7, 1934 (ch. 424, 48 Stat. 919, U. S. C., title 11, sec. 207)," being the language placed in parentheses in the present subsection (f) as set out above in the left-hand column, the following new language, being the language shown in italics in the amended subsection (f) as set out above in the right-hand column: "Chapter 10 of the National Bankruptcy Act as amended by the act of June 22, 1938 (U. S. C., title 11, sec. 501, et seq.)."

The new amendatory subsection (g) set out above in the right-hand column is the heart of the legislation desired by Wabash Railroad Co. in order to put upon a basis of equality under the tax laws all railroad reorganizations and corporate reorganizations whether consummated under the National Bankruptcy Act or under receivership proceedings in a court of the United States. There is no ground for discrimination as between these two procedural methods of attaining the same objective—an expeditious reorganization that will extinguish a debt-ridden corporation without taxable income and substitute therefor a new corporation upon which the Government may rely as a dependable taxpayer.

Congress did not attempt to make the National Bankruptcy Act the exclusive procedure for railroad reorganizations but on the contrary left the equity procedure unimpaired, and this seems also to be true as to ordinary corporate reorganizations which are embraced in chapter 10 of the Bankruptcy Act; Con-

gress recognized that in certain circumstances one of these methods of procedure might be preferable to the other and that in other circumstances the reverse might be the fact, and gave to the railroad companies already in equity receivership the right to transfer to the National Bankruptcy Act, without, however, requiring such transfer, and left both procedures open for future reorganizations. Accordingly, there should be no tax penalty that would destroy or limit the freedom of choice between alternative procedures equally sanctioned and authorized by law.

It may be noted in this connection and in justification, if such be needed, for treating alike reorganizations consummated under section 77 of the National Bankruptcy Act and those carried through in equity, that subsection (n) of section 77, which includes equity receivership proceedings, grants priorities to certain classes of creditors and also that subsection (p) of section 77 imposes in respect to solicitation of stockholders and creditors the same restrictions in equity receivership proceedings as are therein provided for proceedings under section 77 of the National Bankruptcy Act. Neither subsection (n) nor subsection (p) was in the original act. Subsection (n) was amended by the act of August 11, 1939, to include equity receiverships and subsection (p) which extends to equity receiverships, was brought in in its entirety by the amendatory act of August 27, 1935. If equity reorganizations are to be required, as in these subsections provided, to assume the burdens created by said section 77, it follows as a corollary that they should be accorded its benefits and immunities. Such is the essence of equal protection of the laws.

The proposed amendment has been the subject of discussion with representatives of the Treasury Department and of the Joint Committee on Internal Revenue Taxation and no objection has developed from either of these sources; on the contrary Wabash Railroad Company confidently anticipates complete cooperation on their part.

The enactment of the proposed amendment was urged by Arthur K. Atkinson on behalf of the receivers of Wabash Railway Co. at the hearings held on April 1, 1942, before the Committee on Ways and Means of the House of Representatives on revenue revision of 1942. Mr. Atkinson's statement first appeared on pages 1816–18 of the Ways and Means Committee's print of said hearings dated April 1, 1942, and is now set forth on pages 1897 and 1898 of the revised printed record thereof. The House bill, H. R. 7378, which has been reported out makes no provision for the proposed amendment. This bill, however, contains various amendments to prior revenue acts including an amendment to other subsections of section 1808 of the Internal Revenue Code; namely, subsections (g) and (h). The charges proposed by the House in these subsections are preserved in the annexed proposed Senate substitute for section 507 of H. R. 7378, but are relettered "(h)" and "(i)."

The Wabash reorganization is now in the final stages.

The sale at foreclosure of the properties of Wabash Railway Co. under equity procedure was held on December 1, 1941, and the securities of the new company, Wabash Railroad Co. are now in process of distribution. The railroad company has found it necessary to pay under protest substantial stamp taxes pursuant to the present section 1808 (e) in connection with the consummation of the reorganization.

It is vital therefore that in amending the Internal Revenue Act the right of Wabash Railroad Co. to a refund of such stamp taxes be given in clear and express language.

It is respectfully submitted that the setting up of the new subsections (e), (f), (g), and (h), amended as above indicated, will bring all of these sections into harmony and up to date and will place equity reorganizations and bankruptcy reorganizations on an equality, and will accomplish more completely the intent of Congress as indicated by the exemptions given under the National Bankruptcy Act.

For the foregoing reasons, the favorable consideration and action of the committee is urgently requested.

Respectfully submitted.

ARTHUR K. ATKINSON,

Vice President in Charge of Finance of Wabash Railroad Co.,
St. Louis, Mo.

Dated, AUGUST 10, 1942.

EXHIBIT A

PROPOSED SENATE SUBSTITUTE FOR SECTION 507 OF H. R. 7378, UNION CALLENDAR No. 845

SEC. 507. STAMP TAX IN CONNECTION WITH RAILROAD AND CORPORATE REORGANIZATIONS, AND WITH TRANSACTIONS UNDER ORDERS OF SECURITIES AND EXCHANGE COMMISSION

Section 1808 is amended by changing subsections (e) and (f) and by adding two new subsections designated as (g) and (h) and by changing the designation of the present subsection (g) to (i) so that subsections (e), (f), (g), and (h) of said section, as amended, will read as follows:

(e) *Reorganization of railroads under National Bankruptcy Act.*—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under the provisions of section 77 of the National Bankruptcy Act, as amended by section 1 of the act of March 3, 1933 (ch. 204, 47 Stat. 1474; U. S. C., title 11, sec. 205).

(f) *Corporate reorganizations under National Bankruptcy Act.*—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under chapter 10 of the National Bankruptcy Act, as amended by the act of June 22, 1938 (U. S. C., Title 11, sec. 501 *et seq.*).

(g) *Reorganizations in equity.*—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities or making or delivery of conveyances on or after January 1, 1942, to make effective any plan of reorganization approved by any court of the United States in receivership proceedings in such court against a railroad corporation (as defined in section 77 (m) of the National Bankruptcy Act) or in receivership proceedings in such court against a corporation entitled to reorganization under chapter 10 of the National Bankruptcy Act, as amended by the act of June 22, 1938 (U. S. C., title 11, sec. 501, *et seq.*) and any moneys paid for stamps affixed subsequent to December 31, 1941, with respect to such issuance, transfer, or exchange of securities, or making or delivery of conveyances, shall be refunded if a claim for refund is filed prior to March 15, 1943.

(h) *Transactions under orders of the Securities and Exchange Commission.*—The provisions of sections 1801, 1802, and 1821 (b) of this chapter and the provisions of sections 3481 and 3482 of chapter 31 shall not apply to the issuance, transfer, or exchange of securities, or making or delivery of conveyances, to make effective any order of the Securities and Exchange Commission as defined in section 373 (a) of chapter 1: *Provided*, That (1) the order of the Securities and Exchange Commission in obedience to which such issuance, transfer, or exchange of securities, or conveyances are made recites that such issuance, transfer, or exchange, or conveyances are necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820, U. S. C., title 15, sec. 79 (b)), (2) such order specifies and itemizes the securities and other property which are ordered to be issued, transferred, exchanged, or conveyed, and (3) such issuance, transfer, or exchange, or conveyance is made in obedience to such order.

(i) *Cross reference.*—For exemption in case of playing cards exported to a foreign country, see section 1830.

STATEMENT OF JOHN C. WHITE, REPRESENTING SOUTHEASTERN COMPRESS & WAREHOUSE CO., ATLANTA, GA.

Mr. WHITE. My name is John C. White, and I am appearing as counsel for the Southeastern Compress & Warehouse Co.

The CHAIRMAN. You may proceed with your statement, Mr. White.

Mr. WHITE. We are asking for an amendment to section 752 (c) (2) of the Internal Revenue Code.

That section covers what is called the highest bracket amount of a transferee corporation after it had received certain property in exchange for issuance of its stock.

The result of it, so far as this company was concerned, is that its highest bracket amount was reduced from $500,000 to $1,440 as a result of having received from the parent company a small warehouse property which was worth a very small percentage of the total assets of the parent company. The section itself is extremely complicated, and almost impossible to understand on reading it, but in brief the point of it is as follows:

The transferee's highest bracket amount for any taxable year after the exchange shall be an amount which is a percentage of such transferor's highest bracket amount immediately preceding the exchange—

Well, the transferor here had $500,000 highest bracket amount immediately preceding the exchange and the section goes on to provide that there shall be a percentage of that amount—

equal to the percentage which the excess of the transferee's daily invested capital for the day after the exchange over its daily invested capital for the day of the exchange is of such transferor's daily invested capital for the day of the exchange.

We submitted this particular state of facts to the Bureau and they ruled that this meant that the highest bracket amount of the Southeastern Compress & Warehouse Co. was reduced from $500,000 to $1,440.

That means, in effect, that the rate it will pay is uniformly 60 percent for the past year, for the fiscal year ending this year, whereas if it had any highest bracket amount or had been able to keep its prior highest bracket amount, it would be able to pay its excess-profits tax at the graduated rates provided in section 710 (a).

It is plain, from the committee reports, that this section did not take into account transfers between existing corporations.

It was directed at corporate split-ups. In other words, it was intended that, if a corporation transferred some of its property to a new corporation, that then the highest bracket amount of the two companies should be the same as that of the single company before, but by failing to take into account necessary transfers of property between existing corporations and corporate groups, the result of this section is that a highest bracket amount can be entirely eliminated without the knowledge of the corporations involved, because of this very technical section.

That point isn't important for fiscal years ending after 1942, because the graduated excess-profits tax is out.

The CHAIRMAN. You have the flat rate?

Mr. WHITE. That is right. So that this is important primarily for the fiscal year ending 1942.

Now, I have drafted a suggested amendment which would read as follows. It would go to section 217 of H. R. 7378:

Section 752 (c) (2) is amended as of the date of its enactment by inserting at the end thereof the following new language:

"This paragraph shall not reduce the highest bracket amount of an existing transferee corporation, but the net income from the property transferred shall be taxed at the same rate at which it would have been taxed to the transferor corporation if that be higher."

Now, this amendment, I think, would avoid any transfers for the purpose of reducing taxes. It would not protect or cover those, but where a transfer of property was made for corporate purposes quite unrelated to tax problems, this would avoid what seems to us to be a rather inequitable provision, and a purely unintentional provision of the present section 752 (c) (2).

The CHAIRMAN. Have you submitted your suggestions to any member of the Treasury?

Mr. WHITE. That has been submitted to them in a memorandum in the last day or so, but I haven't had any reaction from them.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you, Mr. White.

We will recess until 10 o'clock tomorrow morning.

(Whereupon, at 4:25 p. m., the hearing was recessed, to reconvene at 10 a. m., Thursday, July 30, 1942.)

REVENUE ACT OF 1942

THURSDAY, JULY 30, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in Room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will come to order, please. Mr. Spence.

Senator VANDENBERG. Mr. Chairman, before the witnesses start, I want to bring two matters to the attention of the Treasury for their study, very briefly, if you will permit me. The first point is that the United States Board of Tax Appeals handed down a decision on June 23, 1942, that—

payments received * * * by a naturalized citizen and resident of the United States, from the Canadian Government under its Pension Act as compensation for disabilities incurred from injuries received in 1918 while in active service as a member of its armed forces, are taxable income to the petitioner in the respective years when received.

In other words, although we exempt pensions to American citizens who fought in the World War No. 1 under our flag, we do not exempt pensions to American citizens who fought under the Canadian flag.

I think the situation is so obvious in its inequity that I would like to have it studied with a view to a possible correction of that situation.

The other matter arises in a letter from John L. Lovett, general manager of the Michigan Manufacturers' Association, who points out that when a war contract is renegotiated, even though contractors may have been previously paid on the basis of the original contract, there is no arrangement for a readjustment of the tax, as the result of the renegotiation of the contract, and it is suggested—and I think quite equitably—that something should be done about that.

I would like to have both of those matters referred to the Treasury staff for their study and recommendation.

The CHAIRMAN. On the latter point it will be necessary to do something, and it will also be necessary to take care of the situation where the Comptroller General may disallow the cost item in any plant-expansion program, which disallowance, of course, may come in some subsequent year even after the statute of limitations has applied; because of the volume of work thrown on the Comptroller's office, he may not be able to audit all those accounts and may discover something after the statute of limitations has applied. Some provision, in my judgment, must be put in the bill to take care of that situation.

Senator VANDENBERG. Well, that is precisely the same situation, in general, that I was speaking of.

The CHAIRMAN. Yes; that is true. I do not see any of the Treasury representatives here this morning. Is Mr. Spence in the room?

(No response.)

The CHAIRMAN. Mr. Satterlee.

STATEMENT OF HUGH SATTERLEE, NEW YORK, N. Y., CHAIRMAN, TAX COMMITTEE, NEW YORK COUNTY LAWYERS ASSOCIATION

Mr. SATTERLEE. Mr. Chairman, and gentlemen, my name is Hugh Satterlee. I am a New York lawyer and I appear partly as chairman of the committee on taxation of the New York County Lawyers Association and partly as an individual. I should like to have permission to file subsequently a written statement embodying several points, two or three which I shall mention briefly this morning. That statement will not consist of more than 10 or 15 pages, so I should like permission to file that and have it printed in the record.

The CHAIRMAN. Yes, sir; you may do so.

Mr. SATTERLEE. We all realize, of course, that high taxes are necessary and particularly excess-profits taxes in these times, but that makes it all the more essential that so far as possible, there should be equality of taxation and discriminations should be ironed out.

I have particularly in mind this morning two features of the excess-profits tax law which, it seems to me, call loudly for amendment and modification.

One relates to corporations which, through reorganization, succeed a corporation which at the time of the reorganization had an operating deficit.

Now just briefly, so you can better understand the point I have in mind, under the statute as it stands, of course the invested capital of a corporation consists generally of money and property paid in, plus accumulated earnings and profits, if any, less distributions which have been made otherwise than out of earnings and profits, in other words, distributions of capital.

Even though a corporation has suffered an operating net loss, nevertheless it is still entitled to the original invested capital paid in, which is fair and proper under the principles of the excess-profits tax law, because that is the investment in the business, and of course, corporations often, particularly in their early history, suffer operating losses which are afterward made up. But, at any rate, that is the law now and was the principle adhered to under the excess-profits tax of 1917, 1918, and 1921.

However, an unfortunate situation, unfortunate under the law as phrased today, arises where a corporation with an operating deficit reorganizes into another corporation. Under the statute as it now stands, if a corporation of Maryland, for example, decides that the Delaware law is more favorable and reorganizes under the law of Delaware, with the same stockholders and with the same capital stock, nevertheless, if that Maryland corporation, we will say, had a paid-in capital of $1,000,000 with an operating deficit of $200,000 and if it had continued as a corporation of Maryland without a change in the corporate jurisdiction, it would have been entitled to an invested capital of $1,000,000.

Nevertheless, if it reincorporates in another State, without other changes, its invested capital is reduced by the amount of its operating deficit to $800,000, in the case that I have cited.

Now the bill as passed by the House may, to some extent, remedy that situation. As a matter of fact, I say "may" because I have been studying the matter for the last week or two, and I took this particular question up with two of my partners, one of whom is the former chairman of the Board of Tax Appeals and the other man used to be in the chief counsel's office for a good many years and we reached three different conclusions as to the meaning of the statute.

So I am not very clear as to just what the statute was intended to do, but I think that it may have been intended to accomplish this result, that is to say, where one corporation owns—I am talking now about section 761 proposed to be added to the Internal Revenue Code by section 218 of the revenue bill of 1942—where a corporation owns the stock of another corporation and liquidates that other corporation or merges it or consolidates with it, as I read the statute I think there is a considerable ground for saying that the intention is that the corporation which succeeds to the other corporation by liquidation, merger, or consolidation, shall be entitled to include in its invested capital the invested capital of the corporation that has gone out of existence, without reduction of such invested capital by any operating deficit of the predecessor corporation.

That is fair and reasonable, because the successor corporation, by hypothesis, in that kind of reorganization or liquidation succeeds—steps in the shoes of the predecessor corporation.

However, if the reorganization is effected by a slightly different method as for example in the illustration I cited of a Maryland and Delaware corporation, the Maryland corporation transfers all of its property to the new Delaware corporation in exchange for all the stock of the Delaware corporation, and then the Maryland corporation dissolves and distributes the stock of the Delaware corporation to its stockholders so that the old stockholders of the Maryland corporation become stockholders of the Delaware corporation, and the same stock is outstanding and the same assets are in the enterprise except that there has been a new corporation changed from one State to another, in that event, under the statute as it stands and under the revenue bill as I read it, the new corporation has its invested capital reduced from the original investment by the amount of the operating deficit of its predecessor which is not fair and creates great discrimination between two enterprises which have exactly the same investment but one of which happens to have a change in the place of incorporation or other reorganization.

Now, there is a good deal of difference between a situation such as I have indicated, where the reorganization really becomes a continuance of the same business without substantial change, and the case where one corporation, for example, acquires by the issue of its stock, only part of the property of another corporation. In that case, it is perfectly fair that the corporation which acquires the property should include in its invested capital only the value of that property at the time it receives it, or the basis of the corporation which transferred it, which transferred the property because the corporation which transferred it, having other property, presumably continues in business.

So the corporation which acquires the property is not a true successor to the selling, transferring corporation.

Of course, also in the case of a recapitalization which, under the statute, means simply a change in the corporate structure, in the corporate capital, without reincorporation, in that case a deficit corporation's invested capital is not impaired by the amount of its operating deficit, and it seems utterly unfair and illogical to penalize a corporation which has merely reincorporated, for example, in another State or gone through another reorganization which effects no change in the enterprise, other than having a new corporation possibly in a different State.

So I think, in a case like that, whatever the proposed bill means, there certainly should be a clear provision in the bill to the effect that a true successor corporation—that is the corporation which, by any form of reorganization, stands in the shoes of its predecessor which had gone out of existence—the successor should be entitled to the same invested capital as the predecessor.

Let me give you one more illustration of the unfairness under the statute as it stands. Under the statute as it stands, a corporation succeeding to another by reorganization takes the assets of the other at their basis to the prior corporation and, of course, if there is an operating deficit in the prior corporation, the assets, at their basis to that corporation, add up to less than the original paid-in capital of that corporation.

However, those assets may, in fact, at the time the successor corporation takes them, be worth considerably more than their basis to the prior corporation, which is likely to be cost to the prior corporation.

Using the illustration I made of the corporation with the paid-in capital of $1,000,000, with an operating deficit of $200,000, if that corporation transfers to a new corporation, which becomes truly its successor, the basis to the new corporation and the invested capital is $800,000.

It makes no difference that those assets may be worth $1,500,000, so long as the basis to the old corporation is only $800,000.

So that the result is that the corporation is hornswoggled both ways. The new corporation is not entitled to the invested capital of its predecessor, and it is not even entitled to take the assets at their fair value at the time it receives them. But it seems to me clearly that where a reorganization results simply in a change of form without substantial change in the enterprise itself, that the new corporation should be entitled to the same invested capital as its predecessor corporation.

Senator DANAHER. Mr. Satterlee, may I interrupt you, please?

Mr. SATTERLEE. Surely.

Senator DANAHER. Do you have a copy of the bill at hand, sir?

If not, here is one.

Mr. SATTERLEE. I have a copy right over here.

Senator DANAHER. Directing your attention, please, to page 243, beginning in line 3 and running down through the end of that sentence, does not that take into account, or is not it contemplated to take into account, the situation you are describing?

Mr. SATTERLEE. It is. As I say, in certain situations at least I think it means that, although I am not clear but what the situations are limited. This is section 761?

Senator DANAHER. Yes, sir.

Mr. SATTERLEE. You see it defines, at the beginning of section 761 on page 241, the term "liquidating transaction" as—

the complete liquidation of another corporation under section 112 (b) (6) or the corresponding provision of a prior revenue law, or

The liquidation of another corporation, or a transaction having the effect of liquidating in whole or in part, some or all of the stock of another corporation.

Then having defined a liquidating corporation, it goes on, on page 242, and at the beginning of the subdivision to which you call my attention, subdivision (2) at the bottom of page 242—well, it refers, of course, to a liquidating transaction, and the liquidating transaction under (1) refers to receiving property on the liquidation of another corporation.

That, if apparently your view and mine are right, takes care of the situation where the receipt of the property is by liquidation of the other corporation, but in the instance which I cited, for example, it does not get the property strictly by liquidation.

Let me put to you two different situations. If corporation A acquires all the stock of corporation B by the issue of A stock to the stockholders of corporation B, then having acquired B stock it liquidates B, under this provision by liquidation it gets the assets of B, and my belief is that this was intended to give whatever invested capital it got through getting the property of B, it got the same invested capital as B had.

But, instead of going through that procedure A issues its stock to B for the properties of B, and then B, having received for its properties the stock of A, distributes such stock of A to its stockholders.

Although the result is the same in the two different transactions, simply the order of events is different, and the result in both cases is that the new corporation has the same stockholders and the same assets as the old.

Nevertheless, in fact A has not received the assets of B by liquidation but has received the assets of B by the issue of its stock to B and that is particularly the kind of situation which, it seems to me, should be remedied, because there is no difference, in substance; the only difference is in the form of the reorganization.

Senator TAFT. Is not this language pretty broad, "the liquidation of another corporation, or a transaction having the effect of liquidating in whole or in part, some or all of the stock of another corporation" in the event property is received by the taxpayer? It does not say "purchased." It says "received" in a liquidating transaction.

I should think either of the things you stated would be liquidating transactions. The language is broad enough.

Mr. SATTERLEE. If you go along to page 244, in the middle of the page, you will see—

In determining the amount of the adjustments under subsections (a) and (b), if a corporation owned stock in another corporation, and such corporations are merged or consolidated in a statutory merger or consolidation, or such cor-

porations are parties to a liquidating transaction which results in the liquidation of such stock in a manner similar to that resulting from a statutory merger or consolidation—

then the same result follows.

But it starts out with the condition that the corporation must own the stock in the other corporation.

Senator TAFT. Is this a new provision?

Mr. SATTERLEE. This is entirely new, yes; and, as a matter of fact, one member of the Treasury Department that I spoke to about it said that certainly in the case that I cited the new corporation would not have the benefit of the invested capital of the old, and he doubted if this provision, even in the cases strictly within it, was intended to have that effect.

That is why, it seems to me, in any event, there should be a clarification of these provisions, which nobody seems to have a perfectly clear idea about.

The second feature that I have in mind, the second principal feature, is in connection with section 734, which has been mentioned to you before, and which is still a great source of confusion and dissatisfaction. It cannot be said yet that it has had any serious effects, except as a threat, because it was only enacted about a little over a year ago, and the result of it could only become apparent after the excess-profits-tax returns had been reviewed and additional assessments made in connection with them.

But section 734, to refresh your recollection of it, in effect provides that if, in determining invested capital or net income for excess-profits-tax purposes, a position is taken which, although in conformity with the law as it is now held to be, is inconsistent with the position that was taken in some year back as far as 1913, because in some earlier year the construction of the law by both the taxpayer, the Treasury Department and even by the courts, lower courts, may have been different from what it is now, in that event, if the taxpayer complies with the law as it stands today, but takes that inconsistent position, the Treasury Department may recompute his taxes for any earlier year, and assess an additional income tax which, if less than the excess-profits tax under the present law, will be credited against that tax, and if greater than the excess-profits tax, the Treasury may collect it with interest.

Senator TAFT. That has not been changed in this law.

Mr. SATTERLEE. Nothing was done about it in the Ways and Means Committee. The first result of that statute is, of course, that so far as excess-profits taxes are concerned, it opens wide the whole period of limitation back to 1913 and just takes away the statute of limitations entirely, which we think is a bad enough result and an unnecessary result, and for that reason alone, the statute should be repealed in its entirety.

Of course, the statute of limitations is designed as a statute of repose. Sometimes it works in favor of the Government and sometimes in favor of the taxpayer, but it has always been regarded as beneficial to both in that old matters, once decided, should not be entitled to being reopened indefinitely for all years to come.

So that, it seems any advantages of the statute, if there are any, are more than offset by this fundamental defect, and as a result of that, the statute has the effect of penalizing a correct computation of the excise tax.

In other words, if a corporation computes its excess-profits tax in strict conformity with the law as it is held to be today, but that construction is different in respect to some item from the way the item was treated for income-tax purposes in an earlier year, why, its correct computation is at the price of having to pay an additional income tax for some earlier year.

The alternative is to make a false excess-profits tax return for the current year, which certainly does not seem to be desirable as a matter of policy.

I notice that Mr. Blodgett, of Boston, who appeared before you last August on this same point and who has studied the matter probably in greater detail than I, is on your list this morning and will undoubtedly present the matter fully to you.

But, there is one particular situation with respect to it that I should like to go into, and that is the reference in the statute to the predecessor.

If, to paraphrase the statute, some item has been treated in the past incorrectly for income-tax purposes, either by the taxpayer or by a predecessor, why then the taxpayer is charged, not only with its own income taxes, but also with the taxes of its predecessor, and a "predecessor" is not defined in the statute, and so far as I know, it is the first use of the term "predecessor" as a word of art in any income or excess-profits tax statute.

Originally the Treasury Department promulgated in its regulations a definition of "predecessor" which was wide open and created so much stir that by an amendment it limited the definition to some extent, but in a definition which still is difficult to understand and which is capable of various interpretations. It seems to me that there is some justification for including a predecessor corporation, as well as the taxpayer, if the statute is to stand at all, with certain drastic modifications, provided the predecessor is a true predecessor corporation in the sense that the taxpayer, as I indicated previously in connection with the discussion of the other point, is a true successor.

But, as the definition of "predecessor" stands in the Treasury regulations now, that is not so.

In other words, to take the example given in the regulations, if corporation A transferred some depreciable property to corporation B back, we will say, in 1924 at a time when corporation A was considered to be free from tax on that transaction, and corporation B under the same mistaken view of the law depreciated that property, not at the then value, which was greater than its base to corporation A, so that it took less depreciation than it was really entitled to, as it has since been held, if corporation B now, for excess-profits tax purposes, includes property in its invested capital at its actual value instead of its basis to A, under the regulations of the Treasury Department, it will be charged with the tax which A should have paid on the transfer back in 1924, although A may be still and probably is still in existence, and the only reason it is not charged with the tax is that the statute of limitations had run against it.

In that kind of situation, which is given as an illustration in the regulations of the way section 734 would apply, the successor corporation never benefited in the slightest degree in respect of the position taken by this so-called predecessor corporation.

As a matter of fact, in this very illustration, the fact that both B and its predecessor were mistaken in the view of the law back in 1924 has resulted in the successor or the transferee corporation—it is not a true successor—having received the benefit of less depreciation deductions than it was really entitled to, and yet now, if it takes a correct position for excess-profits tax purposes, it is to be charged with the tax which should have been paid by a seller corporation, a transferor corporation back in 1924.

Now that situation, as I say, certainly should be cured, whatever is done with the statute. On the other hand, it seems to me that there might be justification for taking the position that where the transferee corporation was a true successor to the transferor, as in the case of these organizations I was speaking of a few minutes ago, where the successor succeeded to all the property of the former corporation and had the same stockholders, there is some warrant for going back to the predecessor, because to the extent that the assets of the predecessor were not diminished by the tax which should have been paid, on the present understanding of the law, at the time of the reorganization the successor corporation was benefited because, by hypothesis, it took all the properties of the predecessor and not simply part of the assets.

In other words, both in the case of deficit corporations, of which I spoke somewhat, and in the case of section 734, if it is not to be repealed altogether, it seems to me that the line of demarcation should be whether, in connection with the reorganization the new corporation stands truly in the shoes of the old corporation, or whether it is simply, in effect, a purchaser of part of the assets of the old corporation.

But, I sincerely believe that both these features of the excess profits tax law will have to be and should be thoroughly reviewed and corrected, if there is not to be tremendous discrimination between different business enterprises with truly the same invested capital and the only difference being that some of them may have gone through, for one business reason or another, a form of reorganization.

I thank you, gentlemen.

The CHAIRMAN. Thank you, Mr. Satterlee.

(Mr. Satterlee presented the following supplemental statement:)

SUPPLEMENTAL STATEMENT SUBMITTED BY HUGH SATTERLEE, CHAIRMAN, COMMITTEE ON TAXATION, NEW YORK COUNTY LAWYERS' ASSOCIATION

AUGUST 5, 1942.

HON. WALTER F. GEORGE,
Chairman, Committee on Finance,
The Senate, Washington, D. C.

DEAR SIR: The committee on taxation of the New York County Lawyers' Association, pursuant to authority granted by the Board of Directors, respectfully submits the following recommendations regarding the revenue bill of 1942:

I. INVESTED CAPITAL OF SUCCESSOR TO DEFICIT CORPORATION

In general the equity invested capital of a corporation includes money and property paid in, plus accumulated earnings and profits, if any, less distributions to stockholders which were not out of earnings and profits (Internal Revenue Code, sec. 718). If a corporation has no earnings and profits, but a deficit, it is nevertheless entitled to an invested capital equal to the money and property paid in, the actual investment, provided the deficit is occasioned by operating losses

and not by distributions to stockholders. Of course, any subsequent earnings and profits must first be applied in reduction of the deficit to the amount thereof before they are effective to increase the invested capital over the amount of the cash and property paid in.

In the existing statute the situation of a successor corporation to a corporation with an operating deficit is unfortunate. Even though it stands in the shoes of its predecessor corporation, its invested capital is reduced by the amount of the operating deficit of its predecessor. If the predecessor had a paid-in capital of $1,000,000 and an operating deficit of $250,000, its invested capital was $1,000,000, but if for business reasons the predecessor was reorganized into a corporation of another State with precisely the same assets and shareholders, without interruption of the enterprise as a going concern, the successor corporation would be entitled to an initial invested capital of only $750,000.

Under the revenue bill of 1942 as passed by the House this lack of logic and equity may possibly have been remedied to a limited extent. In section 761, proposed to be added by section 218 of the bill, if a corporation having acquired the stock of another corporation in a transaction in which gain or loss was not recognized liquidates such corporation, or the two corporations are merged or consolidated in a statutory merger or consolidation, then there is included in the equity invested capital of the corporation continuing after the liquidation or merger or consolidation of the other corporation, in lieu of the amounts determined to be otherwise includible in the equity invested capital of such corporation with respect to the other corporation, the amount determined to be necessary to reflect the equity invested capital and the deficit in earnings and profits, if any, of the transferor. Apparently, therefore, if a corporation succeeds to the business and assets of another corporation by first acquiring its stock and then liquidating it, or merging or consolidating with it, the predecessor's invested capital is included in the invested capital of the successor corporation, unless the reference to any deficit in earnings and profits means that the invested capital is to be reduced thereby. Such inclusion is logical and proper because the original investment is continued in the successor corporation except for a change in form not recognized for income-tax purposes.

However, so far as may be inferred from the complex excess-profits-tax provisions of the code and of the revenue bill, if a corporation succeeds another corporation just as effectively and completely as by the methods above specified, but in a slightly different manner, it will not be entitled to the invested capital of its predecessor. If a corporation of Delaware, for example, by the issue of all of its stock acquires all of the assets of a corporation of Maryland which then distributes in liquidation to its shareholders the stock of the Delaware corporation in exchange for their old stock, the Delaware corporation becomes the successor to the Maryland corporation just as truly as though, reversing the order of events, the Delaware corporation had first issued its stock to the shareholders of the Maryland corporation and then acquired the properties of the Maryland corporation by liquidating it. (Cf. clause (C) of section 112 (g) (1) of Internal Revenue Code with clauses (A) and (B)). Nevertheless, in the case of the acquisition of the properties first, as distinguished from the case of the acquisition of the stock first, the result being identical, the successor corporation might have less invested capital than the corporation which succeeded another corporation by a slightly different method.

The acquisition by one corporation in exchange for its stock of only part of the assets of another corporation presents an entirely different situation. There the transferee corporation is not the successor to the business and properties of the transferor corporation, but is only the purchaser of specified assets, which properly should be included in the invested capital of the acquiring corporation at their cost to it or at their basis to the transferor corporation dependent upon whether or not gain or loss was recognized in the transaction. (Cf. sec. 112 (g) (1) (D) of Internal Revenue Code.) It is only where the continuing corporation is a true successor to the predecessor corporation, with substantially all the properties of the predecessor continuing in the ownership of the successor and all the shareholders of the predecessor continuing as shareholders of the successor, however, the reorganization be effected, that the successor should in accordance with the fundamental principles of the excess profits tax include in its invested capital the invested capital of its predecessor. (Cf. sec. 112 (g) (1) (F) of Internal Revenue Code.)

Of course, a mere recapitalization of a corporation without reincorporation and without the payment in for stock of additional capital or the distribution

of existing capital to shareholders does not change its invested capital. (Cf. sec. 112 (g) (1) (E) of Internal Revenue Code.) Equally no change in the investment occurs when a new corporation succeeds the old by a reorganization resulting in the continuance of the same business and assets and the same shareholders. The difference in the form of the reorganzation does not warrant radical differences in the treatment for excess profits tax purposes of the two enterprises.

If section 761 (b) (1) means that, if one corporation which has acquired all the stock of another corporation in a transaction in which gain or loss was not recognized liquidates the other corporation, the transferee corporation shall include in its invested capital the invested capital of the transferor corporation, then the discrimination pointed out above between reorganizations accomplishing the same result may be remedied by inserting a provision extending its benefits to a reorganization effected by the acquisition by one corporation in exchange for its stock of substantially all the properties of another corporation, followed by the distribution in liquidation by the transferor corporation to its shareholders of the stock of the transferee corporation.

On the other hand, if the section is intended to have a meaning different from that above ascribed to it, then the bill should be amended to provide that a true successor corporation shall be entitled to the invested capital of its predecessor corporation, with a definition of predecessor that shall restrict the term to a corporation which shall have been succeeded, however, the reorganization was effected, by another corporation continuing the same assets and the same shareholders. One method of accomplishing the desired result would be by providing that a taxpayer which is an "acquiring corporation" as defined in subdivision (a) of section 740, as amended by section 216 of the bill, shall include in its invested capital the invested capital of a "component corporation" as defined in subdivision (b) (1), (2), (3), and (4) of section 740 as amended. Another method would be to provide that a taxpayer shall be entitled to include in its invested capital the invested capital of a predecessor corporation, "predecessor" being defined substantially as follows:

"A predecessor means a corporation which was merged into the taxpayer, or a corporation which was consolidated with another corporation or other corporations to form the taxpayer, or a corporation which the taxpayer liquidated after acquiring substantially all of its stock, or a corporation which was liquidated in favor of its shareholders after transferring substantially all of its properties to the taxpayer, provided in each case no gain or loss was recognized in the transaction and the taxpayer gave no consideration other than its own stock, except that the assumption by the taxpayer of a liability of the other corporation, or by the fact that property acquired was subject to a liability, shall be disregarded."

(See discussion of "predecessor" under recommendation II relating to sec. 734.)

The need for a revision is emphasized by the present discrimination in favor of a successor to a corporation with accumulated earnings. By way of comparison, assume that corporation A with paid-in capital of $1,000,000 and earnings of $250,000 is reorganized into X, and that corporation B with paid-in capital of $1,000,000 and an operating deficit of $250,000 is reorganized into Y. Under existing law X would have an invested capital of $1,250,000, and even though it should suffer an operating loss of $250,000 in the first year after reorganization, it would still retain an invested capital of $1,250,000. If the reorganization had not taken place and the same operating loss had occurred, A's invested capital would have been reduced to $1,000,000. On the other hand, on the above hypothesis Y would have an invested capital of only $750,000. In short, under the present law it is more advantageous than not for a corporation with accumulated earnings to reorganize, because its earnings become frozen as paid-in captial, while it is disadvantageous for a corporation with an operating deficit to reorganize, because its paid-in capital is reduced by the amount of the deficit. In the case of corporations which several years ago for business reasons reorganized without thought of excess profits taxes, the result is unfair and discriminatory.

The foregoing inequity results from failing to give full effect for excess-profits tax purposes to the principles enunciated in the *Sansome case* (60 Fed. (2d) 931 (C. C. A., 2d Circuit), certiorary denied 287 U. S. 667) and fully accepted for income-tax purposes. There, where a new corporation by the issue of its stock acquired the assets of an old corporation, whose stockholders received the stock

of the new corporation, the court stated with reference to the reorganization provisions that it appeared extremely unlikely that what was not "recognized" as a sale for the purpose of fixing gain or loss should be "recognized" as changing accumulated profits into capital, and held that a corporate reorganization resulting in no gain or loss did not toll the company's life as a continued venture and that what were earnings of the original company remained earnings of the successor. As we have seen, by providing that a transferee has an invested capital equal to the income-tax basis of its predecessor, but without allocating such basis to capital and earnings as required by the Sansome decision, the paid-in invested capital of a successor to a transferor with accumulated earnings is unfairly increased to the detriment of a successor to a transferor with an operating deficit, the basis of whose assets is treated as the invested capital of the successor without allocating it betweeen paid-in capital and operating deficit. If the income-tax rule is to be followed to the extent of limiting a transferee to the basis of its predecessor, even though the value of the assets may be much greater, surely it should be applied to the extent of putting the successor in the same position as its transferor as regards accumulated earnings or operating deficit.

II. REPEAL OR LIMITATION OF SECTION 734 OF INTERNAL REVENUE CODE

Section 734 of the Internal Revenue Code, headed "Adjustment in case of position inconsistent with prior income-tax liability," was added by section 11 of the excess-profits-tax amendments of 1941, approved March 7, 1941, without any opportunity for a hearing on the desirability of its enactment.

In effect the section reopens the period of limitation on assessments and collections of income taxes as far back as the Revenue Act of 1913, not only in the case of the taxpayer, but also of its predecessors in title, by providing that where an item is treated for excess-profits-tax purposes inconsistently with the treatment of such item in the determination of the income-tax liability of the taxpayer, or a predecessor, for a prior year, then the tax liability of the taxpayer for the current year is to be increased by the amount of income tax due for the prior year on the basis of treating the item in the prior year in the same manner as for the current year. In other words, as the price of correctly stating its excess-profits-tax liability for the current year, the taxpayer is required to pay additional taxes for prior years barred by the statute of limitations, even though the difference of treatment in the prior year was in conformity with the law as then construed by the Treasury Department, as well as by the taxpayer, or by decisions of the Board of Tax Appeals and the courts. The purpose of statutes of limitation is defeated.

The section requires a taxpayer to review ancient history to ascertain at its peril whether or not in a previous year an item entering into its accumulated surplus account, for example, has been treated inconsistently, and it permits the Treasury Department to compel the taxpayer either to accept its views in the determination of excess-profits tax or to suffer redetermination of taxes for nearly 30 past years. Because of varying interpretations of the proper treatment of similar items over a long period, it is likely that any treatment of certain items for excess-profits-tax purposes may be inconsistent with the manner in which such items were regarded in some earlier year. The section invites a fishing expedition in waters long since supposed to have been fished out, as a result of which complicated calculations are necessitated, penalizing the taxpayer for past mistakes shared in by the Treasury Department.

The language of the section is intricate and its meaning is incapable of precise delimitation. Perhaps the most patent uncertainty is in the use of the term "predecessor," which is nowhere defined in the revenue acts. The confusion in the statute is reflected in the regulations attempting to apply the section. By Treasury Decision 5045, promulgated May 3, 1941, sections 30.734–1, 30.734–2, 30.734–3, and 30.734–4 assumed to interpret the meaning of the statutory language, including a definition of "predecessor." In consequence of the resulting doubt and dissatisfaction, however, by Treasury Decision 5112, promulgated January 26, 1942, the regulations were amended to formulate an entirely new definition of "predecessor" and to assure taxpayers that a taxpayer was not required to adopt a position inconsistent with the previous incorrect treatment of an item, but might continue the incorrect treatment for excess-profits tax purposes, if the Commissioner did not object, and that a taxpayer who had taken an inconsistent position might, upon notice to the Commissioner in writing, withdraw from

such position. In short, the taxpayer is faced with the alternative of perpetuation of error or penalty for ancient mistakes.

Section 734 is inconsistent with the policy which has existed for so many years of fixing a reasonable period of limitation for the assessment and collection of taxes, and it should be repealed in its entirety. If not repealed, the section should be radically revised and rewritten to limit its application to the accomplishment of such proper purpose, paramount to the established principle of repose, as may be determined to be vital.

Perhaps the most crying need of amendment is for the elimination of any reference to a "predecessor" or for a restricted statutory definition of such term. No one knows what that term was intended to mean, the Treasury Department having tried its hand at two different definitions. Certainly if a predecessor's treatment of an item is to be taken into account, a predecessor for the purpose of the section should be limited to a corporation to whose business and properties the taxpayer succeeded and whose liabilities it assumed. If corporation A reorganized in another State, for example, into corporation B, so that the business of corporation A was continued by corporation B except for a mere change in form, there may not be complaint if B is treated as standing in the shoes of A. But if corporation A merely transfers some of its assets to corporation B, an existing corporation, and both A and B continue in business, it is unfair and illogical to penalize B for a mistake of A and to collect from B a tax which A should have paid and which could still be enforced against it except for the possible expiration of the period of limitation.

Suppose corporation B in exchange for its stock acquires all the stock or all the assets of corporation A, which is thereupon liquidated, so that in either event corporation B continues with the assets and the shareholders of corporation A. Assuming no recognition of gain or loss in the transactions, A is a true predecessor to B, its successor. On the other hand, if corporation B by the issue of its stock acquires some of the assets of corporation A, which continues in business with its other assets, then by hypothesis B is not a true successor to A and A is not its predecessor. If A were so regarded, and A incorrectly treated an item of income, then under section 734 the treatment of such item correctly for excess-profits tax purposes by both A and B would result in charging the additional tax due to the correction against both A and B.

The test should be whether or not the treatment of the item by the transferor corporation benefited the taxpayer. If the taxpayer was a true successor, then any reduction in the tax liability of its transferor would redound to its benefit, but if it merely acquired part of the property of another corporation, any tax saving by its transferor would be a matter of indifference to it. Another criterion is whether or not the transferee has a liability at law or in equity for unpaid taxes or other debts of the transferor, as it would if it received all the assets of the transferor in exchange for the issue of stock or in liquidation, and as it would not if it merely acquired part of the assets of the transferor, whose remaining assets were sufficient to satisfy all its liabilities. Control of the transferee by the transferor, which would often exist where the transfer was only partial, is not significant.

There is already in the statute a definition which broadly describes a predecessor for any reasonable purpose intended. It is suggested, therefore, that at the very least section 734 be amended as of the date of enactment of the Excess Profits Tax Act of 1940 (the date as of which sec. 734 took effect) by adding a new paragraph to subdivision (a) thereof reading as follows:

"(4) The term 'predecessor' means a component corporation as defined in section 740 (b) (1), (2), (3), and (4)."

Another fair, but comprehensive, definition would be as follows:

"(4) The term 'predecessor' means a corporation which was merged into the taxpayer, or a corporation which was consolidated with another corporation or other corporations to form the taxpayer, or a corporation which the taxpayer liquidated after acquiring substantially all of its stock, or a corporation which was liquidated in favor of its shareholders after transferring substantially all of its properties to the taxpayer, provided in each case no gain or loss was recognized in the transaction and the taxpayer gave no consideration other than its own stock, except that the assumption by the taxpayer of a liability of the other corporation, or the fact that property acquired is subject to a liability, shall be disregarded."

These definitions are similar to those proposed under recommendation I relating to the invested capital of a successor to a deficit corporation. A successor corporation which is entitled to the invested capital of a true predecessor corporation, as it should be, is scarcely in a position to protest if it is identified with its predecessor for purposes of the application of section 734, but it would be badly treated if it were saddled with the sins of a transferor whose invested capital was not regarded as continued in a successor corporation.

Other amendments to section 734 which seem most needed are:

1. A provision expressly permitting a taxpayer at any period of a proceeding to alter its position with respect to any item if asserted to be inconsistent with the treatment of such item in a prior taxable year.

2. A provision imposing the burden of proof on the party asserting inconsistency in any proceeding before the Board of Tax Appeals or in the courts.

3. A provision that any adjustment for inconsistency shall not result in a tax greater than if no inconsistent position had been maintained.

4. In any event, a provision for the payment without interest of any excess tax due to an adjustment for inconsistency.

5. A limitation of adjustments for inconsistency to taxable years not earlier than 1932.

III. IMPROVEMENTS TO REAL PROPERTY BY LESSEE

The House has adopted a provision in section 113 of the bill, excluding improvements by a lessee as income to the lessor, to overcome the hardships resulting from the United States Supreme Court decision in *Helvering* v. *Bruun* (309 U. S. 461 (March 1940)), wherein it was held that improvements made by a lessee constituted income to a lessor at the time the lease is forfeited or otherwise terminated and the lessor secures control and possession of the property. Apparently the section was not made retroactive, although this is not altogether clear either from the bill or the House committee report. A history of the situation certainly warrants making the section retroactive to and including the tax year 1937.

Prior to the decision in the Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co.* v. *Commissioner*, 76 Fed. (2d) 880 (1935), the Treasury Department attempted to compel lessors to return as income the value of the improvements erected by lessees, in accordance with the then existing regulations (art. 48, regulations 62, 65, and 69). The *Hewitt case* indicated clearly that a lessor received no taxable income, by reason of improvements made by the lessee, prior to the sale of the property. This determination was followed generally by the Board and the courts. By and large, there were probably no returns of income under the old regulations made subsequent to the *Hewitt case*.

When the Bruun decision came down in March 1940 the Treasury Department immediately picked up those cases which were not outlawed by the statute of limitations (viz: 1937 and subsequent years) and made efforts to assess additional taxes based on income allegedly received under the Bruun decision. Probably many of the cases so involved are still unsettled. The House bill and committee report leave it rather vague as to what the situation is to be with respect to such cases. The committee report states that "if a lessor has paid in prior years tax upon income * * * attributable to the value of improvements made by the lessee, the amount of such income will be added to the basis of the property in order to provide a proper adjustment for the income so taxed." The new section itself, in subdivision (b) thereof (amending sec. 113 of the code), does not speak of payment of tax based on such income, but provides for cost basis adjustment "if an amount representing any part of the value of real property attributable to buildings erected * * * by a lessee in respect of such property was included in gross income of the lessor * * *."

The bill does not state whether the inclusion was by the taxpayer originally or by the Department on an audit. In addition, it would appear to be unfair to charge those cases which were picked up by the Department following the Bruun decision and prior to the taxable year beginning after December 31, 1941, with such income, while permitting others to follow along on the more equitable basis, as proposed by the new section. It is possible that what was intended in the House bill was to leave under the basis proposed in subdivision (c) of section 113 of the code those cases in which payment had been made under the old regulations and where claim for refund would now be barred by the statute of limitations, so that they would at least get the benefit of an increased cost basis,

which is fair enough. If that was the intention, we do not believe it is well indicated in the bill and therefore suggest the addition of a sentence to the new paragraph 10 (in sec. 22 (b)) reading as follows:

"The amendment made by this paragraph shall be applicable with respect to taxable years beginning after December 31, 1936."

The proposed subdivision (b) which adds a new subsection (c) to section 113 of the code, would then remain as it is and apply to those cases where the taxpayer included such income and paid a tax thereon and would now be barred from claiming a refund, except that the date "January 1, 1942," would be changed to January 1, 1937.

IV. LIQUIDATION OF HOLDING CORPORATION

Where a corporation has no assets except all or nearly all of the stock of another corporation, public policy and business convenience favor action to eliminate the holding corporation and vest the stock of the subsidiary corporation directly in the shareholders of the holding corporation. Since no change in the ownership of the individual shareholders in the ultimate assets is affected by such a transaction, except the change of an indirect into a more direct interest, there is no more reason why gain or loss should be recognized than in the case of any other corporate readjustment included within the scope of reorganizations specified in section 112 of the Internal Revenue Code. Where State corporation laws permit, a union of the two corporations may be accomplished without recognition of gain or loss by a statutory merger or consolidation, although the Treasury Department questions such procedure and the decided cases are not altogether satisfactory. (See *Anna V. Gilmore* v. *Commissioner*, 44 B. T. A. 881.)

It is suggested that the elimination of the holding corporation in such a situation should be made possible of accomplishment in the simplest possible manner, namely, by dissolution and liquidation, without recognition of gain or loss for tax purposes. An amendment to the Internal Revenue Code is accordingly proposed to the following effect:

"Section 112 of the Internal Revenue Code is hereby amended by inserting in subdivision (b) thereof a new paragraph (7) reading as follows:

"'(7) Property Received by Shareholders on Complete Liquidation of Holding Corporation.—No gain or loss shall be recognized upon the receipt by the shareholders of stock of a controlled corporation distributed in complete liquidation of a holding corporation. For the purposes of this paragraph a holding corporation shall be considered to be a corporation, substantially all the property of which consists of stock in another corporation of which the holding corporation is in control as defined in subdivision (h) of this section, and a distribution shall be considered to be in complete liquidation only if the distribution by the holding corporation is in complete cancellation or redemption of all of its stock and the transfer of all of its property occurs within its taxable year.'"

V. POWERS OF APPOINTMENT

The Federal estate-tax law now taxes, and since 1918 has taxed property passing under an exercised general power of appointment, that is, a power which can be exercised in favor of the person possessing it or in favor of his creditors or estate (Internal Revenue Code, sec. 811 (f)). The law never has taxed property subject to an unexercised general power, or property subject to an exercised or unexercised limited power; that is, one which cannot be exercised in favor of the person possessing it or for his benefit.

The revenue bill, as passed by the House (sec. 403), proposes to subject to estate tax all powers, general or limited, exercised or unexercised, except certain limited powers.

Section 403 (a) includes in a decedent's estate any propery "with respect to which the decedent has at the time of his death a power of appointment", which is defined to mean any power except powers to appoint (*a*) to the decedent's spouse, descendants of decedent or his spouse, spouses of descendants, and charitable donees, or (*b*) within a "restricted class" if decedent had or acquired no beneficial interest in the property.

Section 403 (c) provides that the executor of a decedent may recover from the person receiving the property by reason of the exercise or nonexercise of the power such portion of the estate tax as the value of the property bears to the net estate and the exemption.

Section 403 (d) provides that the amendments shall not be applicable to (*a*) limited powers released within 2 years after passage of the act; (*b*) limited powers exercised before the enactment of the act; and (*c*) powers released before the enactment of the act.

Section 452 subjects to gift tax the exercise or release of powers of the same character taxed under section 403, and makes the amendment inapplicable to the release or exercise of powers of the kinds and within the periods specified in section 403 (d).

These provisions contain features which seem illogical and unfair, some of which are discussed below.

1. The provisions of the bill apply retroactively to existing powers of appointment. If persons possessed of any such powers relinquish them in order to avoid the estate tax, they may be subjected to gift tax. It is provided that if a limited power is released within 2 years after enactment of the bill, such release will not be subject to gift tax and the power so released will not be subject to estate tax, but similar relief is not extended to existing general powers. An effort to avoid the retroactive operation of the new tax may be unavailing because there is some doubt, as to most of the existing powers which the bill would now tax for the first time, whether they can be released or relinquished under the laws of the various States under which such powers have been created. In many cases powers are vested in infants, who would not be able effectively to relinquish their power until they become of age, perhaps 15 or 20 years from now.

It would seem just that the bill should be modified so that it will not have any retroactive effect but will apply only to powers of appointment created after the enactment of the new law. At the very least the execution of an instrument purporting to relinquish a power should be sufficient to comply with the statute, irrespective of its effect under State law, and in the case of infants they should be permitted a reasonable opportunity after attaining their majority to execute a release. As regards the period within which release is permitted, the holders of general powers should have the same privilege as the holders of limited powers.

2. The distinction which the bill draws between taxable and nontaxable powers seems unsound since taxability depends on the class of persons to whom the property might be appointed, instead of the persons to whom it is actually appointed or to whom it goes because of the nonexercise of the power. The bill would impose the tax on the people who actually get the appointive property, or exempt such persons from tax, depending upon the relationship to the decedent of other persons who might have got it but did not get it. If a decedent had the power under his father's will to appoint property, in which he had a life estate, among his children, and in default of the exercise of the power the property would go to his brother's children, the power would be exempted from the new tax, irrespective of whether the decedent exercised the power and appointed the property to his children or refrained from exercising it and let the property go to his brother's children. However, if the decedent had had the power to appoint the property among all the issue of his father (including his own children and his brother's children), with a provision that in case of his failure to exercise the power the property would go to his own children, then the bill would tax the power, even if the decedent failed to exercise it and let the property go to his children, or even if he exercised it and appointed the property either to his own children or to his brother's children, or partly to both. In the case first put the decedent's nephews and nieces would be exempted from the tax if they acquired the property, while in the second case the decedent's children would be taxed if they acquired it. Yet, in both cases the decedent would have had precisely the same control over the property, the same choice between permitting the property to go to his own children or his brother's children.

The bill provides that the estate tax on a power of appointment may be collected out of the property subject to the power. Since, whenever a power is taxed, the additional tax will be paid by the persons who actually get the property, it would seem reasonable that the question of whether or not the power is to be taxed should depend on whether or not those persons are entitled to exemption. At least it is doubtful whether taxability of the power should be based on the test as to whether or not other persons who might have received, but did not receive, the property are entitled to exemption. If the provision be enacted, it

would seem desirable that it be changed so as to provide that the taxability or nontaxability of powers of appointment shall depend on the identity of the persons who actually get the property, whether by exercise of the power or in default of the exercise of the power, rather than on the identity of the persons to whom it might have been, but was not, appointed. The bill recognizes that spouses and descendants and educational, charitable, etc., institutions ought to be exempt from the new tax, and consequently it ought to provide that property subject to any power (except possibly a general power) which actually passes to such beneficiaries shall be exempt.

3. As regards the classes of powers to appoint which are exempt from tax, it is submitted that there should be included descendants of the donor of the power. Powers of appointment are commonly granted by parents or grandparents to a child or grandchild with the appointment limited to the descendants of the donor. The natural purpose of the creation of such a power is to prevent the property from being dissipated in the event that there should be no descendants of the donee, but should be descendants of the donor. If the execution of the power were limited to the descendants of the donee, the proper objective of the donor, which was not to benefit the donee, but to keep the property in the ownership of qualified members of the donor's family, might be defeated. If a testator gave a power to his two children to be exercised jointly in favor of members of a class comprising their descendants, it would appear that the power might be taxable to both of the donees.

VI. TRANSFERS FOR PUBLIC, CHARITABLE, AND RELIGIOUS USES

The predecessor sections of the internal revenue acts to subdivision (d) of section 812 of the Internal Revenue Code, dealing with the deduction of residuary charitable bequests in computing the net estate for estate-tax purposes, have undergone several changes. The Bureau originally held that only the amount actually received by the exempt legatee was the amount allowable as a deduction. Thus, if the residuary estate, after the payment of all charges but before the payment of the Federal estate tax was $50,000, and the Federal estate tax was $10,000, the Bureau held that the amount deductible was the balance of $40,000. The issue came before the United States Supreme Court in *Edwards* v. *Slocum* (264 U. S. 61), which overruled the Bureau's contention and held that the full amount was deductible without any reduction on account of the estate tax itself. The particular objection urged by the Supreme Court to the Bureau's theory was that it involved two mutually dependent indeterminates and that the solution required the use of an algebraic formula.

Thereupon the Bureau caused an amendment to the Revenue Act of 1924, which provided that where any charitable bequest was subject to any estate tax or inheritance tax, the amount deductible on account of such bequest should be the amount of the bequest reduced by the amount of the taxes. The amendment, however, proved so burdensome and the determination of the tax rendered so difficult on account of the interrelation of State and Federal taxes, that when the Revenue Act of 1926 was adopted a retroactive provision was inserted striking out the clause requiring the deduction of taxes from such charitable bequests as required by the 1924 act. The 1932 act, however, again restored the provisions of the 1924 act requiring the deduction of taxes, and as a result the tax services carry a six- or seven-page formula as the method of finally determining the tax.

It is recommended that the situation be remedied by eliminating the 1932 amendment, and it is therefore proposed that section 812 (d) of the Internal Revenue Code be amended by eliminating the second sentence reading as follows:

"If the tax imposed by section 810, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this paragraph, then the amount deductible under this paragraph shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes."

Respectfully submitted.

COMMITTEE OF TAXATION, NEW YORK COUNTY LAWYERS' ASSOCIATION.

By Hugh Satterlee, Chairman; Robert G. Burke, Mary H. Donlon, Wilbur H. Friedman, Jacob Mertens, Jr., Eugene L. Mullaney, David Oppenheim, Morton Pepper, Weston Vernon, Jr.

Senator VANDENBERG. Mr. Chairman, I presented two letters earlier in the day.

The CHAIRMAN. I wish the representatives of the Treasury would note the suggestions made by Senator Vandenberg earlier, to which he will call attention again.

Senator VANDENBERG. Earlier in the day I presented two suggestions which the Treasury will inquire into, and now hand them to you.

(The letters referred to by Senator Vandenberg are as follows:)

LAWRENCE SCUDDER & CO.,
Grand Rapids, Mich., July 28, 1942.

Senator ARTHUR H. VANDENBERG,
Senate Finance Committee, Washington, D. C.

SIR: The United States Board of Tax Appeals handed down a decision on June 23, 1942, in the case of *H. N. Henry* v. *Commissioner of Internal Revenue* (Docket No. 108258, 47 B. T. A. No. 24).

This decision covered the taxability of pensions received from the Canadian Government under its Pension Act as compensation for disability incurred during the last war by citizens or residents of the United States. The decision is as follows:

"Payments received in 1937 and 1939 by petitioner, a naturalized citizen and resident of the United States, from the Canadian Government under its Pension Act, as compensation for disabilities incurred from injuries received in 1918 while in active service as a member of its armed forces, are taxable income to petitioner in the respective years when received."

During the last World War, upward of 35,000 persons from the United States joined the Canadian Army before the United States entered that war. A number of these individuals were killed in action or died of disease while so serving. In fact, the Canadian Government, according to statistics, was paying pensions to 1,321 dependents resident in the United States, of those who were either killed in action or died of disease. The annual amount disbursed to those dependents was $757,225.

The number of those who joined the Canadian Army from the United States and sustained disabilities from wounds or disease, according to the 1936 statistics issued by the Canadian Government were 6,707 persons receiving disability pensions for a total amount of $2,235,574. The total disability and dependent pensions represented 8.25 percent of the total war pensions paid by the Canadian Government.

On account of the close proximity of the State of Michigan to the Dominion of Canada, a large number of those receiving pensions from the Canadian Government are resident of the State of Michigan. The pension received by many of these pensioners constitutes their entire means of support.

The amount of pension which they receive is not very large and provides a little more than a bare existence. To have it reduced by the payment of income tax coupled with the current increased cost of living, works a hardship on the pensioners, and in some cases at least, may cause them to become partial public charges which is undesirable.

The decision which the Board arrived at is the only one it could arrive at under the present income-tax law.

The acts providing for pensions and similar allowances to the United States veterans of the last war made special provision that these pensions would not be subject to income tax, accordingly, are not taxed. The award of pensions made to Americans and the dependents of Americans who joined the Canadian Army was made for the same reasons as the award of pensions which was made by the United States to its veterans. Although these Canadian veterans did not serve in the United States Army there is sufficient similarity of service to consider the possibility of exempting the pensions from taxation.

At the present time, section 22 (b) (5) excludes from gross income, compensation from injuries or sickness. A war veteran's pension can, in a measure, be considered as compensation for injuries or sickness.

The man is receiving a pension on account of a disability caused either through injury or disease while serving in the Army, but of course, the amount he receives is not from Health Insurance or Workmen's Compensation Acts, and the Board was compelled to rule that it was not exempt under this section. It would appear that a slight amplification of this section would be all that would be necessary to cover the situation.

I am bringing this matter to your attention in view of the fact that, at present, the Senate is considering this year's income tax act and if you consider the subject, favorable action could be taken at this session.

The same situation, of course, will arise out of the present war. It is a well-known fact that a large number of Americans have joined the Canadian Army.

I have the honor to remain,

Yours truly,

(Signed) DUNCAN RICE.

MICHIGAN MANUFACTURERS' ASSOCIATION,
Detroit, Mich., July 27, 1942.

HON. ARTHUR H. VANDENBERG,
Senate Office Building, Washington, D. C.

DEAR ARTHUR: Herewith is a copy of a letter I have received from Mr. C. H. Forrest, of the Falls Spring & Wire Co., Detroit, Mich., who raises some pertinent questions. I am also enclosing a copy of a letter Congressman Roy O. Woodruff sent me from Randolph E. Paul, Assistant to the Secretary of the Treasury Department, Washington, about the renegotiated contracts situation.

I would feel a lot better if there were a provision in the revenue act authorizing the Treasury Department and the Bureau of Internal Revenue to make such reviews and refunds after a contract has been renegotiated.

In other words, an industry has certain earnings on the face of its contract for the year 1942. Sometime early in 1943 this contract has been renegotiated and the company agrees to return to the Government a certain amount but it has already paid income and excess-profits tax.

My thought is that there should be some way of recovery of such excess payments to the Treasury Department because of refunds made on the contract to the particular branch of the armed forces.

This does seem to be very vital and you will find there will be thousands of cases where these returns will have to be kept open and adjustments made.

Mr. Paul indicates that might be done by administrative ruling. I would feel that there would be more protection if in the Revenue Act there was a clause authorizing the Treasury Department, upon request of the taxpayer, to reopen and review the return in the light of the effect the renegotiated contract would have on it.

I feel that unless something of that general nature were placed in the Revenue Act, that the Treasury might well take the position that Congress had not authorized it to take these renegotiated contracts into consideration.

I bring this to your attention because with the bill before you in the Senate, I think you could take care of this without much difficulty. Mr. Paul, I think, understands the problem, and I don't believe that he would have much objection.

Thanking you, I am

Sincerely yours,

(Signed) JOHN L. LOVETT,
General Manager.

(The communications referred to in Mr. Lovett's letter are as follows:)

FALLS SPRING & WIRE CO.,
Detroit, Mich., July 23, 1942.

NATIONAL ASSOCIATION OF MANUFACTURERS,
Detroit, Mich.

GENTLEMEN: I attended the tax meeting yesterday at the Hotel Statler which you held in conjunction with the Michigan Manufacturers' Association and wish to say that I enjoyed it very, very much.

However, it was unfortunate that Mr. Carlton did not happen to be looking my way inasmuch as I had two questions pertinent to the issue to put before the meeting and I would certainly like an expression from your Tax Committee on them.

I left the meeting at approximately 3:15 or slightly before, having overstayed my allotted time at that point. However, there were several digressions that consumed considerable time, questions that did not pertain to the tax meeting whatsoever. This is to be expected at a general meeting such as we had yesterday and interesting as the questions might have been, their discussion denied questions like my own from being answered.

The first question I wanted to put before the meeting was this.

Just what is going to be the position taken by the Bureau of Internal Revenue on depreciation of machinery and equipment used in your normal business but not used in the discharge of your war contracts? Are they going to allow 100 percent of your normal depreciation or have they indicated that this allowance will be reduced to say 50 percent or some other figure?

My second question is this and related to the first.

In renegotiating our contracts, will the Renegotiating Board auditing such contracts eliminate from their costs depreciation on the machinery and equipment used in our normal business but not used in discharge of our Government contracts?

To carry this thought further, if a company is occupying a leased building and using only a portion of that building in the discharge of their Government contracts, will that company be allowed to apply the cost of the entire building to the cost of the contract?

These two questions seem to be uppermost in our minds at the present time and if you have any solutions to these problems, we will appreciate it very much if you will forward them to us.

Very truly yours,

FALLS SPRING & WIRE CO.
(Signed) C. H. FORREST.

TREASURY DEPARTMENT,
Washington, D. C., July 21, 1942.

Hon. ROY O. WOODRUFF.
House of Representatives,
Washington, D. C.

MY DEAR MR. WOODRUFF: Reference is made to the letter received by you from John L. Lovett, Detroit, Mich., dated July 6, 1942, which you handed to me.

Mr. Lovett is interested in the problem of firms which have subcontracts with firms holding contracts from the Government and which are obligated to renegotiate such contracts if the prime contractor is required to renegotiate its contracts.

He suggests that some provision be made in pending legislation to allow such companies to file amended returns and recover back amounts paid in excess of the liability determined in the light of required adjustments.

The Bureau of Internal Revenue is presently working with the War Department on the tax problems arising out of the requirements for the renegotiation of contracts. Although this study has not yet been completed, it seems likely that the problem raised by Mr. Lovett can be handled administratively.

I would suggest that he advise the firm in which he is interested to submit to the Bureau of Internal Revenue detailed facts concerning its situation, in order to insure that the Bureau has that problem in mind in connection with its general study.

I am returning herewith the letter from Mr. Lovett.

Sincerely yours,

(Signed) RANDOLPH E. PAUL,
Assistant to the Secretary.

The CHAIRMAN. Mr. Priest.

STATEMENT OF BENJAMIN B. PRIEST, OF HALE, SANDERSON, BYRNES & MORTON, BOSTON, MASS.

Mr. PRIEST. Mr. Chairman, and gentlemen of the committee, my name is Benjamin B. Priest. I am an associate in the law firm of Hale, Sanderson, Byrnes & Morton, in Boston.

I am submitting a written memorandum concerning some suggestions that we have to make regarding the excess-profits tax. I would be perfectly content to rest on this memorandum except for the fact that, unfortunately, it was written and prepared before the act which has been passed by the House was available to us.

Consequently, you will find that the mathematical examples contained in the memorandum are now incorrect, and that the mechanical

suggestion we have for the relief will probably be altered because of the new method of imposing the income and excess-profits tax.

Our suggestion is limited to corporations in bankruptcy or that are insolvent and in receivership, and is further limited to those corporations in that situation which the court feels have an opportunity of working out of receivership or bankruptcy.

Our suggestion is based on two major premises: First of all, it is for the benefit of the Nation and the public to maintain as many corporations as possible in a going position, financial position, so that they are operating as a going concern, without deterring the war effort or the public policy.

I think there are several reasons for this. First of all, so that goods may be produced during the emergency and after the emergency as well, to supply civilian needs, so that after the war emergency is over, there may be employment for men who are now engaged in the war service, and, not the least important, so we may have a source of revenue, present and future.

Another reason is that with the excess-profits rate applied to the income of the corporation in bankruptcy or receivership, it will, in most instances, make it impossible for that corporation to continue and work itself out of its unsound financial condition, and it may result in a condition where the courts will refuse to allow a corporation to continue to do business in receivership because of the fact that they will have the alternative of long years before they would be able to pay off the claims of the creditors or, of liquidation, to protect the creditors.

Now, our suggestion is, very briefly, this, that we exclude from the high rate of the excess-profits tax, but not from the rate of regular income tax that amount which is used or irrevocably set aside to pay the claims of creditors which, of course, were incurred before bankruptcy or receivership.

Now, this can be done very simply. We suggested a new provision to be added to section 711 that this amount be treated as a deduction in determining the excess-profits net income.

Senator TAFT. Would not that make it rather desirable for a corporation to go into receivership, if it is near the edge?

Mr. PRIEST. If it were too close to the edge, it might, Senator Taft, but most corporations would prefer to keep their credit and also avoid the expense of receivership, which, in general instances, would be more than if they were running as a going concern.

Senator TAFT. If they could go into receivership and pay their debts instead of staying in business and not paying their debts, would not that be the case?

Mr. PRIEST. Our suggestion is limited for that very reason to corporations which are insolvent and in receivership or in bankruptcy, and as soon as they became solvent or relieved from the control of the court, then, at that point, of course, the exception would no longer apply. We would try to meet the Senator's suggestion in that way.

Senator DANAHER. Would not the petitioning creditors put it in receivership, whether the company liked it or not?

Mr. PRIEST. Yes; I think probably they would, Senator. Our suggestion here would be if it was so hopelessly insolvent that the court would declare it as insolvent, then it would have this relief only to the point where it would become solvent and relieved from the control of the court.

Now, the suggestion of deducting this amount in order to determine your excess-profits net income would not apply under the present revenue act, and, therefore, I suggest in order to accomplish the same result, if the committee wishes, this could be done, again in a very simple, mechanical way, by merely allowing an addition to the credit, to your excess-profits credit, of such amount as is used or irrevocably set aside to pay the claims of the creditors so long as the corporation remains insolvent and under the control of the court.

In making this exception to the application of the excess-profits tax, we do not feel we are in any way circumventing the purport of the act or decreasing the possibility of revenue. The purport of the act is to prevent people, as I understand it, from becoming enriched from profits resulting from the war emergency, and by exempting this amount, it would in no way enrich the stockholders, because the amount would go solely to creditors for value received and the stockholders would not receive any of the excess-profits over and above the average profit which might be incurred because of the war emergency.

As a matter of fact, as long as the corporation remained in receivership or bankruptcy, the stockholders would receive nothing from the income.

We tried to cover in detail in the brief, the argument with reference to that, and that applies regardless of the change in the law.

Now, as far as revenue is concerned, it may be true we would lose a small amount of present revenue. Comparatively, it would be an extremely small amount, but we feel it would benefit the country to perhaps take this small present loss, in view of the fact that, as soon as these corporations became solvent and came out of bankruptcy and receivership there would be additional revenue, and not only would they then become subject to the income tax and excess-profits tax without exception, but they would also become subject to the capital-stock tax, the declared-value excess-profits tax, and also, the unlawful withholding of a surplus from distribution for which a corporation in receivership or bankruptcy is not responsible.

Now, also in the memorandum are cited examples whereby similar relief has been given to the corporations in other taxes. I do not wish to take the time of the committee with reference to that. I merely wanted to point out the change that will have to be made with reference to our memorandum because of the new act which has been passed by the House.

Thank you very much, gentlemen, for your courtesy.

The CHAIRMAN. Thank you, Mr. Priest, for appearing here.

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

SUGGESTED RELIEF FROM EXCESS-PROFITS TAX TO CORPORATIONS IN BANKRUPTCY OR RECEIVERSHIP, SUBMITTED BY BENJAMIN B. PRIEST, OF HALE, SANDERSON, BYRNES & MORTON, BOSTON, MASS.

PROBLEM

Some corporations are so hopelessly insolvent that they are placed in bankruptcy or receivership for the sole purpose of liquidating the assets immediately. The excess-profits tax creates no great problem for these concerns. The businesses are doomed.

On the other hand, many corporations although overwhelmed with debts at the present are in such financial condition when they enter bankruptcy or receivership that the court may feel that it is justified in ordering the continuation of the businesses with the prospect that the creditors can be paid in full from the busi-

ness income, the businesses salvaged for the stockholders, and the public benefited by having them continued in existence through future tax revenue, production of materials, and employment of people. It is with reference to these corporations that a real problem is created by the excess-profits tax.

A receiver or trustee in bankruptcy who is conducting a business with a view to paying creditors and eventually returning a going concern to the stockholders has first to pay the current expenses of running the business and then from the profits pay off debts accrued in prior years of operation in receivership or bankruptcy, improve and perhaps expand the business facilities to place the business in a condition to compete with other businesses and thus insure some future income and then from the profits remaining, if any, retire indebtednesses incurred prior to bankruptcy or receivership. The primary purpose of his appointment was to pay the claims of the creditors and yet if the business income is taxed to the vanishing point he cannot do this and continue the business. The only alternative is to dissolve and liquidate the business. When the need during the present war emergency for materials and tax revenue and after the war not only for materials and revenue but also for the employment of people released from the war effort is considered, it is submitted that it is to the interest of this Nation to save and preserve all businesses that it can without deterring the war effort and weakening public policy.

There are so many variables involved in computing the excess-profits tax that it is difficult to determine any example which might be labeled as an average situation. Ignoring the possibility of a carry-over, if the excess-profits credit is zero the amount of annual income left after paying an excess-profits tax of 94 percent and an income tax of 40 percent would reach a minimum amount of 3.6 percent with which must be paid other taxes and the above mentioned debts and capital investments. It is obvious that as the amount of the excess-profits credit approaches the amount of annual income the amount of that tax approaches zero and the regular income tax approaches 40 percent of the income. The maximum amount which could be retained after paying these two taxes, again ignoring loss carry-overs, would be 60 percent of the net income.

The variables with which we are concerned are the amounts of the base period average income or the equity invested capital and the amount of the creditors' claims. Since the corporation is now in receivership it is fair to assume that its average net income during the base period from 1935 to 1940 would be comparatively small. Its excess-profits credit if computed on base-period income would, consequently, be small, and the amount of income left after taxes would be relatively close to the minimum of 3.6 percent of income. On this basis it would be practically impossible to work the corporation out of receivership.

The ratio which the amount of invested capital bears to the amount of annual income will determine the percentage of net income exempted from the excess-profits tax computed by the invested capital method. If the invested capital is zero only the minimum amount of income could be retained and as it approaches the ratio to income of 14 or 16 to 1 the amount of income which could be retained approaches the maximum. If invested capital and income were equal there would be remaining 7.15 percent of the income. If it were 3 times as much as the income the amount remaining would be 15.6 percent of the income. If it were 6 times as large, the percentage would be 27 percent of the income. If 10 times, the percentage would be approximately 48 percent.

The length of time required for the business to become financially sound would depend upon how long the good business cycle continued, how much would be available to pay the creditors and how much their claims amounted to. It has always been true that periods of depression alternate with periods of business activity. A corporation in receivership cannot count on continuance of enough income to liquidate past debts for more than a few years at a time. The amount of claims which a receivership must pay is not measurable in general average terms because of the vast difference in circumstances which lead to receivership. It is, however, reasonable to suppose that any corporation, when it is forced into receivership, has accumulated a very substantial amount of unpaid bills and has exhausted or nearly exhausted its credit. It is likely that the amount of such unpaid bills will amount to two or three times the average annual net income. If it is assumed that claims to be paid equal twice the net income, the taxes under the proposed program leave income available to liquidate only 2 percent of such claims per year at the worst and 20 percent per year at the best. Thus it would take at least 5 years and more likely something approaching 50 years to dissolve a receivership and at the same time avoid destruction of plant capacity

and organization and displacement of labor. The courts in general are not patient with receiverships which continue year after year. Some Government agencies have exerted their efforts to bring receiverships to a quick conclusion. If the alternative to immediate sale and liquidation is a long span of years in which debts are to be paid off at a small percent a year it is almost certain that courts and receivers will find it necessary to abandon thoughts of saving the organization and will be forced to sacrifice values and organization notwithstanding the loss to the public of a going, producing enterprise, the loss to labor of employment and the loss to the Government both in substantial bad debts charged off and in the loss of a potential taxpayer.

SUGGESTION

Amend section 711, Internal Revenue Code, by adding at the end of subsections (a) (1) and (a) (2) thereof a new paragraph containing the substance of the following:

"There shall be deducted from the normal-tax net income of domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia the amounts used or irrevocably set aside during said year to pay duly approved claims filed in bankruptcy or receivership and bona fide indebtednesses of said corporations incurred prior to bankruptcy or receivership, or renewals thereof."

Under the provisions of this subsection if money were actually paid as a dividend on the claims of the creditors during the year, or if the court approved a partial dividend during the year and for the sake of convenience ordered the money to be set aside and accumulated for payment in a subsequent year, the amounts so paid or set aside would not be subject to the excess-profits tax.

ARGUMENT

When a corporate business is being conducted and carried on in receivership or bankruptcy all control and management is ousted from the corporation and its stockholders and is vested in the receiver (subject to court order) or the trustee (*United States* v. *Whitridge*, 231 U. S. 144, 58 L. Ed. 159).

The income from the business passes into the hands of the receiver or trustee to be used, in brief, to pay the expenses of conducting the business and the court proceedings, and to pay the claims of creditors which accrued prior to receivership or bankruptcy, and which have been made unenforceable directly against the business assets by action of court and law.

All of this income is at present subject not only to the normal and surtax income taxes but also to the excess-profits tax. Under the proposed amendment all of the income would remain subject to the normal and surtax income taxes and all of the income except that used to pay the legal obligations of the corporation incurred prior to receivership or bankruptcy would be subject to the excess-profits tax. When the receivership or bankruptcy proceedings terminated, the exception would be no longer applicable.

The amendment is urged for the reason that the results accomplished thereby would not nullify or circumvent the purposes and principle of the excess-profits tax, are just and equitable, and would be for the best interests of the public and Government. Moreover, the relief suggested is similar to that given under other taxes to corporations overburdened with debt.

I. *The amendment would not nullify or circumvent the purposes and principle of the excess-profits tax*

A. *Purposes and principle of the excess-profits tax.*—One of the purposes of the excess-profits tax was, of course, to raise revenue, but another purpose just as strong, if not stronger, was to regulate the amount of profit which might be made in this period of war emergency so that it would not exceed the average annual profit for a certain period prior to the emergency or, in the alternative, a certain percentage of the capital invested in the corporation. The underlying principle of the tax is to prevent any person or persons from being enriched from business profits which were made because of the circumstance of war. The House Ways and Means Committee in submitting the first Revenue Act of 1940 stated in explaining the excess-profits tax feature of the act:

"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" (1940-42 Cum. Bull., 508 (H. Rept. No. 2491, 76th Cong., 3d session, June 10, 1940)).

The same committee in its report numbered 2895 and dated August 28, 1940, which accompanied the second revenue bill of 1940, reaffirmed and approved the above statement of its purpose. (See 1940-2 Cum. Bull., 496.)

B. *The amendment would not result in the unjust enrichment of any person or persons.*—The income exempted from the excess-profits tax by the amendment would go only to creditors of the corporation who are prohibited by force of law from enforcing their claims against the corporation. They would not be enriched for they furnished full value in the past for what they would receive.

The stockholders of the corporation could not receive any of this income and if any of the other income was used by the receiver or trustee to improve or expand the business for the creditors' present and the stockholders' ultimate benefit, that income would have been subject to the excess-profits tax.

It may be argued from an economic point of view that the stockholders would gain financially to some extent because if income used to pay creditors' claims were exempted from the excess-profits tax, more money would be available to pay creditors and the corporation would approach solvency at an accelerated rate. As the time neared when the corporation could emerge from receivership or bankruptcy the corporation's stock would near the point when it would again have some pecuniary value. Thus it might be said that the amendment would serve to enrich the stockholders because it would hasten the time when the stock regained some monetary value or would accelerate the rate of increase in the value of the stock. It is submitted that such an enrichment would be extremely small, not within the purport of the excess-profits tax, and furthermore could be largely accounted for by the use of the income which was not used to retire the claims of creditors and on which the excess-profits tax was paid. Any gain in the value of the stock would of course be taxable when the stock was transferred.

C. *The amendment would cause no loss of revenue to the Government.*—Compared to the entire tax program, the amount of revenue which the Government might lose by the amendment would be infinitesimal. Moreover, a substantial part of the apparent revenue loss might be recouped in other ways. It is entirely probable that the creditors of the corporation in receivership or bankruptcy may have written off part or all of their claims as bad debts and taken deductions therefor in their tax returns. When the exempted income is applied to the payment of their claims, therefore, the creditors would be required to report it as income and pay a tax thereon. These income-tax collections would in part, and in some cases wholly, compensate for the loss of the excess-profits tax on the business income so used. Also, present and future creditors of corporations in bankruptcy and insolvency would not be able to claim successfully that the corporation's debts could be written off as bad in view of the provisions of the proposed amendment and consequently their income taxes would be higher because their deductions would be lessened. Even though there is some comparatively small loss of present revenue it is submitted that it would be more than offset by hastening the time when the Government would collect taxes from a going concern which would be in a sound financial condition and subject to more and larger taxes than it would have been in receivership or bankruptcy. Once the corporation recommended to conduct and carry on its business it would again be subject to the capital stock tax, the declared value excess-profits tax, and the tax on improperly accumulated surplus, and it is fair to assume that its taxable income would be as great, if not greater, than it was when the receiver or trustee was conducting the business.

II. *The amendment is fair and equitable and for the best interest of the public*

Generally, a business is carried on in receivership of bankruptcy for two reasons: First, to protect the creditors against further loss and pay them in full if possible; and, secondly, to salvage the business for the stockholders.

It is not equitable to jeopardize the creditors' chances to receive payment in full by imposing the high excess-profits tax on all income received by the business and

thus diminish any excess over the business and court expenses which would be applied to pay their claims. The purpose of the excess-profits tax is to keep this excess small so that stockholders will not receive unduly large income from the business. In this case, however, the excess would be used to pay creditors and would not enrich stockholders. It is submitted that the payments of these frozen claims of the creditors should be allowed as a deduction in determining the receiver's or trustee's net income subject to the excess-profits tax just as a trustee is allowed to deduct from the income of the trust for tax purposes all income which is distributable to the beneficiaries. In this way the excess-profits tax will apply only to that part of the business income which might enure to the stockholders' benefit and will not impede the payment of the creditors' claims which was the primary purpose of the receivership or bankruptcy proceedings. This is the result which the amendment seeks to accomplish. It would not allow a double tax deduction for these debts for, although they have previously been deducted from income for regular income-tax purposes, they have never been deducted in determining net income for an excess-profits tax and under the proposed amendment they would not now be deducted again for regular income-tax purposes.

The amendment is fair to the stockholders. It would allow the corporation to rid itself of its oppressive debt burden in shorter time and start business anew with the opportunity to replenish the capital investment of its stockholders and with the prospect of being able at some future date to pay them a reasonable return on their money invested in the corporation.

Moreover, it is submitted, the amendment would be for the best public interest. It will accelerate and assist the progress of a corporation in emerging from receivership or bankruptcy and when the court control is terminated the Nation will have acquired a financially sound corporation which will not only be required to furnish more revenue in the form of taxes but will be able to do so and which will be capable of continuing in business both during and after the war emergency manufacturing materials and employing people, rather than succumbing to liquidation in the hands of a receiver or trustee in bankruptcy.

III. *The relief given by the amendment to corporations overburdened with debt is similar to that granted them under other taxes*

A. *Undistributed profits tax.*—A surtax on undistributed corporate profits was established by the Revenue Act of 1936 and, although incorporated with the normal tax in the Revenue Act of 1938, the undistributed-profits feature was retained until repealed by the Revenue Act of 1939. (See 1936 Revenue Act, sec. 14; 1938 Revenue Act, sec. 13.)

Under both acts, corporations in bankruptcy or insolvent and in receivership were exempted from the undistributed-profits tax. (See 1936 Revenue Act, sec. 14 (d) (2); 1938 Revenue Act, sec. 13 (e).)

This tax was regulatory and was designed to force distribution of profits to the stockholders by means of taxable dividends. It was obviously unfair to apply its high rates to the income of corporations in bankruptcy or receivership for the law prevented the distribution of income to stockholders. The profits of the business which might ordinarily have been available for dividends were required by law to be used to pay the claims of creditors.

The situation under the excess-profits tax is very much the same. The tax is designed to regulate the income available to be distributed or accumulated for the stockholders, but if the corporation is in receivership of bankruptcy the income required to be used to pay creditors' claims cannot possibly be made available to stockholders and should not, therefore, be subject to the regulatory excess-profits tax.

Of particular interest is the Senate Finance Committee's discussion of the House committee's suggestion that a corporation should be exempt from the undistributed profits tax if it was in bankruptcy or receivership for only part of the taxable year. In acquiescing in this House proposal the committee said:

"This proposal is founded on the principle that if a corporation goes into bankruptcy or receivership after its taxable year has started, it is so weak that an undistributed profits surtax ought not to be or cannot be imposed upon it. Similarly if it comes out of bankruptcy or receivership during its taxable year, it should be allowed to operate free of such tax during the remainder of the year in order to recover its strength" (1939-2 Cum. Bull. 687 (S. Rept. No. 2156, June 1, 1936)).

The advisability of allowing an insolvent corporation an opportunity to regain its financial strength free from taxation of an extraordinary sort has thus been recognized by both branches of Congress.

B. *Personal holding companies—surtax on undistributed income.*—In determining the income taxable as undistributed under subchapter A, section 504 (b) of the Internal Revenue Code provides for a deduction from net income of—"amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness."

All corporations whether solvent or insolvent are given relief by this section from debts of long standing. Before they are forced under threat of penalty taxation to distribute their income they are permitted to retire long established debts and thus render their financial position more sound.

The same type of relief is also found in Internal Revenue Code, section 27 (a) (4) which is apparently no longer applicable to any particular tax.

C. *Miscellaneous.*—Some relief from regular taxes is also extended to financially unsound corporations by the following:

> Internal Revenue Code, section 22 (b) (9) (exclusion from gross income). Regulation 103, section 22 (a)-14.

For the above reasons we respectfully urge the adoption of an amendment similar to that suggested herein.

HALE, SANDERSON, BYRNES & MORTON.

BOSTON, MASS.

The CHAIRMAN. Mr. Blodgett.

STATEMENT OF GEORGE R. BLODGETT, OF HERRICK, SMITH, DONALD & FARLEY, BOSTON, MASS.

Mr. BLODGETT. My name is George R. Blodgett. I am an attorney, a member of the law firm of Herrick, Smith, Donald & Farley of Boston, and I do much corporate tax work.

I shall talk about section 734—the so-called inconsistency section, about which Mr. Satterlee has just spoken to you. I did not know he was going to speak this morning, and I think I can omit quite a little of my talk as the result of his excellent presentation.

I urge the repeal of the entire section, or if repeal is not accepted, its great revision. The American Bar Association and local bar associations have formally urged repeal of the entire section.

I appeared before you on this subject last August. I thought the members present felt that some action should be taken, but action was deferred with other technical matters which were to be included in a separate technical bill never adopted.

Section 734 makes provision for adjustments in cases of so-called inconsistent position. Its underlying purpose is apparently to prevent a taxpayer from reducing its excess-profits tax through unconscionably reversing a position which had been erroneously allowed to it in some income-tax matter of a prior year and which had reduced its tax for that prior year. But it goes beyond such a purpose and produces totally different and unfair results as I shall show by illustrations.

I will not stop to explain the wording of the section as Mr. Satterlee has just done this.

This provision has much greater scope than a statute merely waiving the statute of limitations back to 1913 because—

First, it permits the Government to reopen specific tax liabilities previously brought to a final court or board decision between the tax-

payer—or a "predecessor"—and the Government, even a decision of the Supreme Court of the United States in a case between the same parties on the same transaction.

Mr. Satterlee has pointed out that the term "predecessor" is not in any way defined in the law. It is not a technical term the meaning of which is established. The regulation on the subject is most un-understandable, and we can only be sure that it departs substantially from the statements made in the committee report when the section was adopted.

The second reason why the section has much greater scope than a statute merely waiving the statute of limitations back to 1913 is because it imposes on a taxpayer the unpaid tax liabilities of other independent taxpayers for which it may never have been liable under former law, and over which it never had any control.

It is not my purpose to discuss the philosophy underlying the section. I shall talk only about the hardships, resulting from the present wording, to taxpayers who are striving not to take inconsistent positions or to be otherwise unfair.

This section has no place in an excess-profits tax law. The purpose of the excess-profits tax credit is to exempt from the excess-profits tax a certain amount of current income, determined by earnings from 1936 to 1939 or by the investment and accumulated earnings. Mistakes made 20 years ago in determining the taxes of this taxpayer or of some so-called predecessor, have no bearing on the amount of current earnings to be deemed excessive.

Mr. Satterlee has told you that the term "predecessor" is entirely undefined, and the same may be said as to the term "maintaining a position." The regulations have attempted to define both terms, but they are to me, un-understandable and unsatisfactory in other respects. In any event, they are of very doubtful validity, unsupported by anything in the law, and they are subject to retroactive change by the Commissioner at any time.

Using an extremly simple example to illustrate some of the difficulties with section 734, assume that in 1924 a going corporation A, the buyer and the present taxpayer, issued substantial amounts of its stock and money to corporation B for property in a transaction which everyone has always correctly treated as fully taxable to B, the seller, but which nevertheless constituted a reorganization under the tax law which results in what is technically a substituted basis though actually the same amount as a cost basis. Many transactions are technically "reorganizations" although the full profit is taxed. The value of that stock when issued is material in computing corporation A's invested capital for excess-profits tax purposes in 1942 and its depreciation in intervening years. While the value of stock is always a matter of opinion, let us assume that $200 a share was the correct value and is the one which the corporation has consistently used and which the Bureau after investigation has always accepted. Nevertheless, if the 1924 taxes of the seller, corporation B, were determined by using a value of less than $200 a share, the buyer and the present taxpayer A will be liable for all the 1924 taxes of B thereby avoided plus 6 percent interest thereon since 1924.

The section has imposed on corporation A, the buyer, an entirely new liability to pay someone else's 1924 taxes for which it could never

have been liable under the 1924 law or under any other law until section 734 was enacted in 1941.

Corporation A, the buyer and taxpayer, might not have any 1942 current excess-profits tax even if the stock were valued at zero. If so, it is not doing anything, either fair or unfair, to reduce its excess-profits tax. Nevertheless section 734 applies; it has maintained an inconsistent position and must pay the seller's 1924 taxes. This seems to me to be a basic difficulty with section 734—it imposes a penalty which may be of staggering size and bear no relation to the excess-profits tax saving resulting from the change of position. Often a staggering penalty where there is no excess-profits tax on saving at all. Any such result is squarely contrary to the underlying purpose of the section to prevent reduction of excess-profits tax through unconscionable changes of position.

Further difficulties are encountered by corporation A, the buyer. It may be impossible, certainly it would be difficult, to find out what value the seller B put on the stock it received 17 years ago, as B may be out of existence or its records destroyed. Other practical difficulties are encountered, yet under established principles the burden of proving the various facts before the Bureau of Internal Revenue, the courts, or the Board of Tax Appeals is on the taxpayer.

Corporation A, the buyer, may choose to use $150 per share on its excess-profits tax return rather than the correct $200. If the Commissioner does not choose to attack the $150 figure, even though he knows it is wrong, the taxpayer is liable for additional taxes for every intervening year from 1924 to the present which result from reducing its annual depreciation allowance on the property because of this reduction in cost, as well as any 1924 deficiency in taxes of the sellers resulting from their having used a value of less than $150.

In short, A, the buyer and present taxpayer, has no choice but to take some inconsistent position and to pay some prior year penalty.

Senator DANAHER. Mr. Blodgett, if the language with reference to the liability of a predecessor were eliminated from section 734, would not that meet most of the objections that you raise with reference to it?

Mr. BLODGETT. That would meet many of the objections. I was planning later on to outline three or four additional things. I would be glad to do it now, if you wish.

Senator DANAHER. No; you may defer it.

Mr. BLODGETT. That would meet many of the difficulties of imposing on the taxpayer the liabilities of someone else over which it had no control.

Senator DANAHER. Thank you. Pardon the interruption.

Mr. BLODGETT. If it uses the higher correct value for the stock it issued it may be inconsistent with the seller's treatment in 1924 and may have to pay the seller's 1924 tax; if it uses a low value it is surely inconsistent with its depreciation treatment in the past and may have its taxes reopened for all the years back to 1924.

Many of the defects in the law are well illustrated by the only example of its operation given in the present regulations. The example I am giving is taken exactly from the regulations. It is the only example given there.

A taxpayer acquired depreciable property in 1934 from a so-called "predecessor" for stock in a transaction which was incorrectly treated

in 1934 by the predecessor as a nontaxable exchange. From 1934 to 1940 the taxpayer based its depreciation deductions on the predecessor's low cost, and thereby overpaid its income tax in all of those years. If the transaction had been correctly treated as taxable, it would have had a higher cost and have had higher depreciation and less tax in its preceding years. On its 1940 excess-profits-tax return the taxpayer claimed the correct higher basis of the property for invested capital purposes.

Under section 734 taxpayer's 1940 excess-profits tax is increased by the amount of the tax which the predecessor should have paid on the exchange, plus interest, less the taxes overpaid by the taxpayer, plus interest, because of its too small depreciation deductions.

In this example the acquiring corporation is forced solely by section 734 to bear the burden of the predecessor's 1934 taxes on the exchange, for apparently it would not have been otherwise liable therefor whether or not the statute of limitations had run. The two corporations were not in any way interconnected or with common stockholders, and the present taxpayer, the purchaser, had, so far as the regulation indicates, no control over or knowledge about the seller's taxes.

First, let us notice that the taxpayer is penalized, even though it had no current excess-profits-tax liability to pay, whichever position is taken about the taxability of the 1934 exchange. The example in the regulation gives no indication that, aside from this adjustment, the taxpayer had any excess-profits tax. It pays the penalty anyway.

Second, what could the successor corporation have done to avoid this penalty?

The 1934 transaction was probably one which was correctly treated under the then current decisions as a tax-free reorganization but which under the more recent court decisions should have been taxable.

May the taxpayer, in order to avoid the section 734 penalty of having to pay the predecessor's tax, maintain in its excess-profits tax return that the transaction was nontaxable? That is the way it was treated in 1934 but incorrectly. Such a consistent position would not only result in probably higher taxes for the intervening years but would also involve the filing of a return which was knowingly false in the light of recent Supreme Court decisions. If the taxpayer has the right to file such knowingly false returns, any such right should be very clearly stated in the law.

There is no suggestion anywhere in the law that it is anything except a criminal offense to file knowingly a false return.

An amendment to the regulations last January might, with some difficulty, be construed as a permission by the Commissioner to file such an incorrect return. If the Commissioner is willing that the taxpayer should file a knowingly incorrect, though consistent, return, the law should so state in unmistakable language and not leave it to an indirect implication contained in the regulations.

Third, in the example in the regulation, the predecessor corporation clearly should, in all fairness, bear the burden of the tax. There is nothing in the regulations to indicate that the predecessor corporation has gone out of existence or that it is without assets, or anything else about its present status. But no provision of the law or regulations permits either the Government or the successor, which pays that tax as a penalty under section 734, to recover the tax from the prede-

cessor, even though it is active and solvent and may have agreed with the successor to discharge all tax liabilities determined against it.

Fourth, the only reason why, even under the amended regulations, the successor corporation in the example which I have taken from the regulations is liable under section 734 is that the other corporation is made a "predecessor" solely because of the fact that the present taxpayer incorrectly used the other corporation's low basis of the assets for the purpose of depreciation in the years between 1934 and 1939. Of course, the effect of this error was to increase, rather than decrease, the present taxpayer's taxes for those years.

It might have been hoped that the penalty would be applied only in cases where the present taxpayer is making a manifestly unfair claim. But neither the law nor the regulations contain even an intimation to that effect, and I have not learned of any instructions by the Commissioner to his subordinates which indicate any discretion at all in the matter.

Taxpayers cannot hope that the Board of Tax Appeals or courts will apply the law any differently than they find it in the Internal Revenue Code.

While believing that the section should be entirely repealed, a group of people interested in this section have suggested amendments designed to:

(1) prevent this section from applying to very old transactions and to limit it to transactions in some recent period, such as the last decade;

(2) limit the definition of "predecessor" to corporations over whose prior year action the present taxpayer or its stockholders had control because of stock ownership, and so forth.

Senator DANAHER. Or knowledge, knowledge of what they had done.

Mr. BLODGETT. I should think not. When would the knowledge be acquired?

Senator DANAHER. I do not know, unless it would be actual knowledge, because they surely could have guarded against it, that is all.

Mr. BLODGETT. I have a number of cases, about six, going as far back as 1917, and I cannot find out anything now about the 1917 transaction, even if I travel all over the country. I cannot conceive how it could now be established whether or not my client had knowledge in 1917. Certainly I cannot find out anything now.

(3) give the taxpayer a right to maintain a consistent position.

There is no such permission in the law to maintain a consistent position which is necessarily an incorrect one.

(4) put the burden of proving any inconsistency upon whichever party, taxpayer or Treasury, is trying to profit by claiming the inconsistency;

(5) limit any penalty to the amount of the saving of the current excess-profits tax which results from maintaining the inconsistent position;

(6) eliminate the interest on the prior year deficiency.

I ask permission to include the text of the amendments prepared by these people as an addition to the record. These amendments were not drafted by me and they do not represent my ideas in all particulars. Nevertheless, I think they will be helpful.

(The text of the amendments referred to is as follows:)

SEC. 734. ADJUSTMENT IN CASE OF POSITION INCONSISTENT WITH PRIOR INCOME TAX LIABILITY (added by sec. 11, Excess Profits Tax Amendments of 1941).

(a) DEFINITIONS.—For the purposes of this section—

(1) Taxpayer.—The term "taxpayer" means any person subject to a tax under the applicable revenue Act.

(2) Income tax.—The term "income tax" means an income tax imposed by chapter 1 or chapter 2A of this title; Title I and Title IA of the Revenue Acts of 1938, 1936, and 1934; Title I of the Revenue Acts of 1932 ~~and 1928; Title~~ II ~~of the Revenue Acts of 1926 and 1924; Title II of the Revenue Acts of 1921 and 1918; Title I of the Revenue Act of 1917; Title I of the Revenue Act of 1916; or section II of the Act of October 3, 1913; a war profits or excess profits tax imposed by Title III of the Revenue Acts of 1921 and 1918;~~ or ~~Title II of the Revenue Act of 1917~~; or an income, war profits, or excess-profits tax imposed by any of the foregoing provisions, as amended or supplemented.

(3) Prior taxable year.—A taxable year beginning after December 31, 1939, shall not be considered a prior taxable year.

(4) Predecessor.—The term "predecessor" means a person (other than the taxpayer) who at a time when it controlled the taxpayer or was controlled by the taxpayer transferred property (i) which for income-tax purposes for any taxable year, has at any time been treated, or (ii) which is treated for excess-profits-tax purposes, under this subchapter, as having in the hands of the taxpayer a substituted basis (as defined in sec. 113 (b) (2)) determined directly or indirectly by reference to the basis in the hands of such person. The term "controlled" as here used has the same meaning as "control" under section 112 (h).

Adjustments for inconsistency relative to a predecessor shall be made only in those cases which have to do with the basis to the taxpayer of property transferred by a predecessor to the taxpayer and to the recognition or nonrecognition of gain or loss in connection with such transfer.

(b) CIRCUMSTANCES OF ADJUSTMENT.—(1) If—

(A) in determining at any time the tax of a taxpayer under this subchapter an item affecting the determination of the excess-profits credit is treated in a manner inconsistent with the treatment accorded such item in the determination of the income-tax liability of such taxpayer or a predecessor for a prior taxable year or years; and

(B) the treatment of such item in the prior taxable year or years consistently with the determination under this subchapter would effect an increase or decrease in the amount of the income taxes previously determined for such taxable year or years; and

(C) on the date of such determination of the tax under this subchapter correction of the effect of the inconsistent treatment in any one or more of the prior taxable years is prevented (except for the provisions of section 3801) by the operation of any law or rule of law (other than section 3761, relating to compromises),

then the correction shall be made by an adjustment under this section. If in a subsequent determination of the tax under this subchapter for such taxable year such inconsistent treatment is not adopted, then the correction shall not be made in connection with such subsequent determination.

(2) Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the net effect of the adjustment would be a decrease in the income taxes previously determined for such year or years) or by the taxpayer with respect to whom the determination is made (in case the net effect of the adjustment would be an increase in the income taxes previously determined for such year or years) which position is inconsistent with the treatment accorded such item in the prior taxable year or years which was not correct under the law applicable to such year.

In filing a return, or in any subsequent proceeding with respect to the determination of tax liability, no provisions of this subchapter shall be deemed to require a taxpayer to maintain a position with respect to any item which is inconsistent with the treatment accorded such item in the prior taxable year or years which was not correct under the law applicable to such year; and the Commissioner, the Board of Tax Appeals, and the courts shall, on demand of the taxpayer made at any time before entry of judgment, determine the tax liability by treating any such item in a manner which shall not be inconsistent

with the treatment accorded such item in the prior determination. In any proceeding before the Board of Tax Appeals or the courts the burden of proof in establishing that an inconsistent position has been taken, and the amount of the adjustment resulting therefrom, shall lie with the party asserting such inconsistency.

(c) METHOD AND EFFECT OF ADJUSTMENT.—(1) The adjustment authorized by subsection (b), in the amount ascertained as provided in subsection (d), if a net increase shall be added to, and if a net decrease shall be subtracted from, the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent position is adopted.

(2) If more than one adjustment under this section is made because more than one inconsistent position is adopted with respect to one taxable year under this subchapter, the separate adjustments, each an amount ascertained as provided in subsection (d), shall be aggregated, and the aggregate net increase or decrease shall be added to or subtracted from the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent positions are adopted.

~~(3) If all the adjustments under this section, made on account of the adoption of an inconsistent position or positions with respect to one taxable year under this subchapter, result in an aggregate net increase, the tax imposed by this subchapter shall in no case be less than the amount of such aggregate net increase.~~

(3) The amount of the adjustment under this section made on account of the maintenance of an inconsistent position or positions with respect to one taxable year under this subchapter shall in no event exceed the amount of the difference in excess-profits tax which results from the maintenance of the inconsistent position as compared with the amount of excess-profits tax which would have been payable if a consistent position had been maintained; and the aggregate amount of the adjustments under this section for all years shall in no event exceed the amount of the income taxes determined for prior years resulting solely from the incorrect treatment of such items in such prior years.

(d) ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.—In computing the amount of an adjustment under this section there shall first be ascertained the amount of the income taxes previously determined for each of the prior taxable years for which correction is prevented. The amount of each such tax previously determined for each such taxable year shall be (1) the tax shown by the taxpayer, or by the predecessor, upon the return for such prior taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer or such predecessor upon the return, or if no return was made by such taxpayer or such predecessor, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax. There shall then be ascertained the increase or decrease in each such tax previously determined for each such year which results solely from the treatment of the item consistently with the treatment accorded such item in the determination of the tax liability under this subchapter. ~~To the increase or decrease so ascertained for each such tax for each such year there shall be added interest thereon computed as if the increase or decrease constituted a deficiency or an overpayment, as the case may be, for such prior taxable year.~~ There shall be ascertained the difference between the aggregate of such increases, ~~plus the interest attributable to each,~~ *without interest*, and the aggregate of such decreases, ~~plus the interest attributable to each,~~ *without interest*, and the net increase or decrease so ascertained shall be the amount of the adjustment under this section with respect to the inconsistent treatment of such item.

The CHAIRMAN. Did you appear before the Ways and Means Committee?

Mr. BLODGETT. I did; yes, sir.

The CHAIRMAN. The Ways and Means Committee did nothing?

Mr. BLODGETT. The Ways and Means Committee did nothing; but I believe there have been some discussions between the staff of the Joint Committee on Internal Revenue Taxation and the Treasury

Department, and perhaps it was in the light of those discussions that the Ways and Means Committee did nothing. I think there was some thought that amendments might be made later in this section.

The CHAIRMAN. The position of the Treasury Department has been it could be done by regulation which could prevent the unusual result which you point out, and which others have pointed out, I believe.

Your position is that the statute itself ought to be clarified.

Mr. BLODGETT. I think the statute should be clarified. The people with whom I talk find the amendments which the Treasury made as the result of recent clamor in the Ways and Means Committee appearance quite unsatisfactory and vague, if nothing else.

I doubt whether many of these points, such as waiving the 6-percent interest, and the permission to file knowingly false returns, can be taken care of by regulation.

The CHAIRMAN. Thank you very much, Mr. Blodgett.

Senator DANAHER. Mr. Chairman, before we conclude with him, I would like to ask one other question.

The CHAIRMAN. All right, Senator.

Senator DANAHER. You remember, Mr. Chairman, last year we were all very much impressed by the equity of the claim and we reserved action on this feature of the then bill before us, because we expected that administrative relief would come up in a bill that never did come up.

I would like to know if Mr. Blodgett is in a position to tell us how adversely the Treasury's position would be affected if section 734 were repealed entirely? Are you in a position to comment on what would be the effect on the Treasury were we to repeal section 734?

Mr. BLODGETT. I do not see how I could honestly make any estimate on the figures. I do not see that I can say anything beyond my feeling that the injustice far outweighs any benefit to the Treasury.

Senator DANAHER. I think it ought to be out of the bill entirely.

All right, thank you.

Senator WALSH. Are many taxpayers affected by this?

Mr. BLODGETT. Well, I have myself not 10 taxpayers, but 10 reorganizations, many of which go back to 1917. On most of them I cannot find a single fact. The old company has gone out of existence, its records are destroyed. Of course, the Bureau will not let me see the tax returns of an entirely independent taxpayer in 1917, even if the Bureau has them. I can find nothing. I have traveled around the country, trying to find something. If we move it up to some recent year, say 1932, it would not be so terrible, but to go back to 1913 is totally impractical.

The CHAIRMAN. Thank you very much, Mr. Blodgett.

Mr. Clapp.

STATEMENT OF A. W. CLAPP, VICE PRESIDENT, WEYERHAEUSER TIMBER CO., TACOMA, WASH.

Mr. CLAPP. Mr. Chairman and members of the committee, my name is A. W. Clapp. I am vice president of Weyerhaeuser Timber Co., Tacoma, Wash.

The statement I would like to make also relates to section 734, although it is a rather limited feature. After Mr. Satterlee's and

Mr. Blodgett's statements, I do not need to explain the general purposes of section 734 to this committee, but I think it would be helpful to give a specific illustration of an inconsistent position and how it results.

My company in 1927 sold to another wholly unrelated company a large block of timber under an installment contract.

In 1933, in the depths of the depression, and at a time when most of the installments remained unpaid, my company had to cancel the contract and retake the timber. The Internal Revenue Bureau had regulations providing for computation of profit or loss on the cancelation of such an installment contract.

In making its income-tax return for 1933, the company followed the Bureau's regulations and what at that time both it and the Commission believed to be the law.

Recently the courts have decided that the regulation was not in accordance with law and have laid down the correct rule for computing profit under the law in force in 1933 in cases of cancelations of installment contracts. The court's decision was followed by the Commissioner, who now has regulations which embody it. Under this correct rule we should have returned and paid for 1933 a tax on a profit of a very considerable amount more than we did. But the year 1933 was "closed" when the court decisions were made.

In making our 1940 excess-profits tax return, we included in our surplus account as part of invested capital the profit which, under the correct rule, we made in 1933.

But as that position is inconsistent with that taken by us in our original return for 1933 we were required under the provisions of section 734, and did, recompute our tax for 1933 and paid, as a part of our excess-profits tax, the deficiency in the 1933 tax, together with interest at the rate of 6 percent per annum from the date when it should have been paid.

There is no question of a predecessor company here, and if section 734 is to be retained, we make no objection. It may be fair that we should pay this deficiency and interest if we desire to include the previously untaxed profit in our invested capital.

But the law as now written, as we understand it, as interpreted by the regulations does not provide for deduction at any time of the interest which we have paid from our earnings.

Our position is that there should be a proper amendment to section 734 providing that the interest which is included with the deficiencies for prior year which the taxpayer must add to its excess-profits tax payment may be deducted from its earnings when paid, and conversely that interest included with overpayments for prior years which the taxpayer may deduct from its excess-profits tax otherwise payable must be included in its earnings when it receives such credit for that interest.

While the previous speakers have spoken of the inconsistent position taken by taxpayers, the committee, of course, realizes that when the Commission, in auditing the first excess-profits tax return of a taxpayer, maintains a position which is inconsistent with what was done in prior years, resulting in the lowering of the income in those prior years, the taxpayer is given credit in its excess-profits tax for what

should have been refunds in those closed years, a refund of the amount of the overpayment in the closed year, plus interest.

Senator VANDENBERG. In other words, you follow the inconsistency between the regulation of the Commissioner and a subsequent ruling of the court.

Mr. CLAPP. Yes; we followed the regulations of the Commissioner at the time we made our return.

This is the first instance, to my knowledge, that taxpayers have not been allowed a deduction for interest paid on income-tax deficiencies, and the first instance that interest upon refunds or credits for overpayments have not been required to be included in the taxpayer's gross income.

We believe that the failure to provide for the deduction of interest in case where the adjustment is for a deficiency in a prior closed year or for the inclusion in the gross income of a corporation of the interest for which it receives credit (in case where an adjustment made as a result of an inconsistent position maintained by the Commission there is disclosed an overpayment in a prior closed year) must have been an inadvertence.

Heretofore, under all revenue acts, interest on deficiencies has been a deductible item, and interest on refunds an addition to gross income. The principle of section 734 has, with respect to positions maintained by a taxpayer in a current income tax return (or by the Commissioner in auditing it) inconsistent with income tax returns (or determinations) for prior closed years, has been in the Internal Revenue Code for several years as section 3801.

Deficiencies or overpayments for years as far back as 1932 (but not prior), even though the years are "closed" so that the statute of limitations otherwise precludes additional assessments or refunds, may be determined under circumstances similar to those covered by section 734, and deficiencies for prior "closed" years assessed, with interest, or refunds made, with interest.

Interest on such deficiencies is deductible when paid, and interest on such refunds when paid or credited included in gross income.

Furthermore, adjustments under section 734 apply only to years which are "closed."

By a closed year, of course, we mean a year for which the statute of limitations has run, so there could be no deficiency assessed or refund made.

If a position maintained by a taxpayer in computing its excess profits tax is inconsistent with that taken in an income tax return for a year not "closed," section 734 does not apply. In that case the Commissioner will assess in the ordinary course, as additional income taxes, deficiencies for the prior year, the deficiency will be paid with interest and the taxpayer given a right to deduct the interest in computing its earnings in the year paid.

Conversely, if a position maintained by the Commissioner in determining a taxpayer's excess profits tax is inconsistent with the treatment of the item in determining the income tax for a prior year which is open (for refund), the taxpayer will be entitled to and in the ordinary course be paid a refund with interest and the taxpayer required to include that interest in its gross income for the year paid (or credited).

There is no reason or logic whatsoever in this different treatment of interest paid by the taxpayer on deficiencies or paid (or credited to the taxpayer) upon refunds for "closed" years and like interest paid or received on account of deficiencies and refunds for "open" years. That there was no real intention in section 734 to make such a distinction seems clear from the following language in clause (d) of the section [parentheses and italics supplied]:

> To the increase or decrease so ascertained for each such tax for each such (prior) year there shall be added interest thereon *computed as if the increase or decrease constituted a deficiency or an overpayment* as the case may be, for such prior taxable year.

There is, of course, no way in which we can tell whether the amendment suggested by us will produce more or less revenue. It would seem to me reasonable to suppose that the Commissioner may make more adjustments, thus entitling taxpayers to reduce their excess-profits taxes by the amount of overpayments disclosed for prior years with interest that taxpayers will make. If that is so, revenues would be increased by such an amendment.

I understand that there is no question of revenue involved. I think the Treasury will tell you the chances are with the amendment we suggest the revenues would not be affected.

Now, unquestionably, most adjustments made by taxpayers under section 734 were made in making their first excess-profits return for 1940, and most adjustments made by the Commissioner will be made in auditing those returns. In either event, interest on deficiencies will be paid and interest on overpayments credited in 1941.

Therefore, whatever amendment is adopted should be made retroactive so that it will have the same effect as if included in the original section 734. We have no fear but that this will be acceptable to the Treasury.

The subject which has so far been discussed was presented by me to this committee on August 15, 1941, when the Revenue Act of 1941 was under consideration. After my presentation the following occurred (record of hearings, pp. 560–561):

> The CHAIRMAN. On the face of it, it looks like your complaint is very well founded. I think the Treasury ought to make a special note of that——
> Mr. RAY.—

who was the representative of the Treasury then present—

> Yes, Senator George.
> The CHAIRMAN. And see how that may be remedied.
> Mr. RAY. The Treasury is considering this particular section with respect to that point and a number of other points. It is a very specialized problem, and we will look into it, sir.

During the same colloquy Senator Danaher said he thought I was right and asked the Treasury representative (Mr. Ray) "why they should permit deduction of interest paid on a deficiency for an open year and deny the deduction of interest paid on a deficiency for a closed year."

No report on the subject was made by the Treasury to the Finance Committee. Presumably the committee would have taken no action anyway because it decided that no "administrative" amendments, so-called, should be considered at that time.

The same subject was presented by me to the Ways and Means Committee in March 1942, during hearings on the bill now before

you. No action was taken by that committee, on section 734, at all.

I am reliably informed that the reason for this was that while the Treasury representatives and the legislative counsel for the Joint Committee on Internal Revenue Taxation agree that an amendment should be made curing the particular point which we have urged, there was some difficulty in agreeing upon other amendments to the same section (734) and in the rush to complete drafting of the bill for the Ways and Means Committee, revision of section 734 had to be postponed, presumably for presentation to this committee.

I have been informed that there will be amendments submitted to this committee on section 734, I mean, by the Treasury Department and the counsel for the joint committee.

We insist that there being no objection of any kind from anyone, but on the contrary a general agreement with our position, there should no longer be any delay in the adoption of a proper amendment. We assume that such an amendment will be drafted and submitted to the committee by the legislative drafting experts. If that is not done, we suggest that the following, if adopted, would be sufficient and proper:

(a) Subsection (d) of section 734 of the Internal Revenue Code is amended by adding at the end of said subsection the following:

"If the amount of the interest on increases which is included in the computation of such adjustment exceeds the amount of the interest on decreases which is included in the computation of such adjustment the amount of such excess shall be deductible from the gross income of the taxpayer in the year in which the adjusted excess-profits tax is payable; if the amount of the interest on decreases which is included in the computation of such adjustment exceeds the amount of the interest on increases which is included in the computation of such adjustment, the amount of such excess shall be added to the gross income of the taxpayer in the year in which the adjusted excess-profits tax is payable."

(b) The amendment made by subsection (a) shall be effective as of the date of the enactment of the law amended thereby.

The correction of this is a simple matter.

The CHAIRMAN. The suggested amendment deals only with this question?

Mr. CLAPP. This particular question that I have discussed so far.

The CHAIRMAN. The interest question?

Mr. CLAPP. The interest question, yes; that particular amendment.

I feel I must say something else about section 734. I add this because this is a matter that came up just before I left Tacoma, in fact the week before I left Tacoma.

It concerns, I would say, a threatened construction and application of section 734, which I think is so far inconsistent with the real intent and purpose of the section that I think it should be called to the attention of the committee.

It arose, by the way, in connection with a conference over the excess-profits tax return of my company for the year 1940, and this is what developed: We were told that, while the examining agent agreed with the position which we had taken in making our excess-profits tax return and certain adjustments under section 734, they had been advised or believed that the construction to be given in certain circumstances by the Treasury Department would be different, and I want, by illustration, to point out what that was.

Now, it may be, it seems to me as a lawyer, that the construction which is threatened would be wrong, but I think it should be called to

the attention of the committee, and I think the committee should ask the Treasury experts or representatives whether such construction could be or would be given by the Treasury. Now, the illustration is this, and this is an illustration which shows what our position was and the way the point came up before the internal-revenue agent in charge at Seattle.

A corporation had, and its return showed, a very serious net loss in 1933, say for the purpose of illustration of $100,000 net loss in 1933.

Its return was accepted by the Commission. Of course, there was no tax paid or payable, and no tax determined, except as the return showed that there was no tax.

In making its excess-profits tax return for 1940, the corporation treats an item in such a way that if it had been treated consistently in its return for 1933—I have already explained the kind of inconsistency—it would have added $125,000 to its gross income and resulted in a net income of $25,000 instead of a net loss of $100,000 for that year.

Now in this instance, the question is, what is the increase in such tax previously determined for such year which results solely from the treatment of the item of $125,000?

We have been informed—and this is what we fear—that the Treasury will hold that the increase would be a tax on $125,000 rather than a tax on $25,000.

Now that is in spite of the fact that if the taxpayer had properly treated, in accordance with the law, as it actually was, if the taxpayer had properly treated the item in his 1933 return, it would then have paid a tax upon only $25,000, because its other loss would have absorbed most of that profit.

We submit that such result could not have been in contemplation by Congress, and that far beyond causing an inequity to the taxpayer, it imposes upon him the grossest and most unpardonable inequity.

Now the trouble with section 734, if there is any trouble—I do not say that there is, but I think the committee should ask the Treasury whether a thing of this kind could be done—if there is any trouble with section 734 as at present worded, it deals only with the tax previously determined. Now the people at Seattle, while they haven't yet ruled this way, have said there cannot be any minus tax, therefore you have to start with zero and you compute the tax on whatever the adjustment is, the total amount of the adjustment. Although had you included that adjustment originally, it would have been offset by other deductions—by a loss.

Here again, we would have, if such a ruling is possible, an entirely different treatment of doing equity for a closed year than for an open year.

If, in the example given above, the year was 1939, no adjustment would be made under section 734, but the Commissioner would assess an extra tax for the year 1939 upon $25,000, not upon $125,000.

It seems to us that this demonstrates an obvious fault if any such construction, as we have been told may be made, should be made by the Treasury Department, and we ask that the committee ascertain from the Treasury Department whether such treatment is possible and, if it is, it should be corrected.

Very obviously, what was intended was when an adjustment is made to correctly reflect the law now, in its excess-profits-tax return

what it should do is to go back and see whatever deficiency there would be in the tax, and that deficiency of course should be computed by the determination made by its own return in computing its loss or gain, whichever it should be, and adding to that loss or gain the amount of the inconsistent item.

The CHAIRMAN. You may me laboring under a misapprehension, Mr. Clapp. The Treasury may not take that view.

Mr. CLAPP. That is true.

The CHAIRMAN. But suppose you take the case where the recognition of losses by the Department was exactly $125,000, and subsequently the Treasury found you should have, in computing your income tax, computed an omitted item of $125,000, certainly the Treasury would not then insist that they would take that separate item out of the related return in transactions for that year and tax you on the $125,000.

Mr. CLAPP. Well, I say they certainly should not.

The CHAIRMAN. No.

Mr. CLAPP. But you will note that the law itself speaks of determination of a tax. It makes no reference to the determination of the company's net income or the company's loss.

The CHAIRMAN. That would certainly be resorting to a technicality and would be an extremely harsh and inequitable rule. I do not think the Treasury would do that.

Mr. CLAPP. I do not think it would, but I do think it should be called to the attention of the committee. It is an illustration which has been called to our attention. It is, you might say, a threat that has been called to our attention.

The CHAIRMAN. It is an imminent danger.

Mr. CLAPP. It is an imminent danger.

The CHAIRMAN. Thank you, sir.

Mr. Brooks.

STATEMENT OF JOHN W. BROOKS, REPRESENTING PASS & SEYMOUR, INC., SYRACUSE, N. Y.

Mr. BROOKS. Mr. Chairman and members of the committee, my name is John W. Brooks.

I am vice president and treasurer of Pass & Seymour, Inc., located at Solvay Station, Syracuse, N. Y. We manufacture electrical lighting supplies essential to the war effort; employ approximately 625 people.

Our invested capital as of January 1, 1942, was approximately $1,600,000.

I am not proposing to take your time with our detailed historical figures, but rather to discuss some of the principles of the proposed corporation's normal, surtax, and excess-profits tax and the apparent effect on our corporation, our employees and others similarly situated.

I will ask for the privilege, Mr. Chairman, of filing a supplement, more lengthy memorandum.

The CHAIRMAN. Yes, sir; you may file a supplemental memorandum, if you desire to do so.

Mr. BROOKS. One hundred percent of our present output is classified as being necessary to the war effort. All expansion to convert

and produce has been financed by the company with their own capital, plus borrowing, from our local bank.

We fully recognize the need for higher taxes to finance the war. It is, however, necessary to determine how far smaller companies can go in paying taxes and at the same time have enough left to finance the jobs it is essential for them to do.

This is especially true in the durable goods industries, most of which are essential.

Reference to the data which you have will show that the durable goods industries, which are compelled to use the invested capital basis, because of small earnings in the base period, pay a much higher rate of tax than the nondurable group. The separation is very marked, running as high as 20 points and up; in other words, 50 to 60 percent of net in some instances before Federal tax as compared with over 80 percent in many durable goods industries.

I make that statement, Senator, on the basis of figures prepared for me by Standard Statistics.

Could these inequalities be leveled out by introduction of higher brackets for invested capital credits, below $5,000,000 level?

In other words, a percentage ration for the first million, again for the second and for the third, and finally reaching the present 8 percent at the $5,000,000 level.

I am concerned about the impact of the proposed taxes—normal, surtax and excess-profits tax, on our own company taking as it will over 83 percent because:

(*a*) Will make it difficult to finance needed equipment and inventory for the war effort;

(*b*) Distribution of tax does not appear to me to be fairly spread among all interests.

By that I mean in comparison with nondurable goods, mail-order houses, soft-drink manufacturers, and others of that type who, because of the nature of their business, enjoyed an earning record in the base years which is denied to the durable goods on the basis of their experience.

After all, the nondurable-goods companies who had good earnings in the base period should be just as much interested in financing the war.

(*c*) I am concerned about the possibility of carrying on after the war, providing employment for the hundreds of people who look to us to provide employment (as many have for over 50 years).

In closing, I fully recognize the most difficult task which confronts the committee. If the submission of any of our detailed data would help, you have but to ask.

Senator CONNALLY. Just one question.

You say nearly all of your products are regarded as necessary for the war?

Mr. BROOKS. That is right.

Senator CONNALLY. You are, therefore, getting a higher price, of course.

Mr. BROOKS. No; the same prices we had been getting.

Senator CONNALLY. The same prices you had been getting over a period of years?

Mr. BROOKS. Yes. Our prices are frozen by O. P. A.

Senator CONNALLY. Were your profits during the 4-year base period fairly satisfactory?

Mr. BROOKS. No, sir; they were not.

Senator CONNALLY. They were not?

Mr. BROOKS. They were very unsatisfactory. You will recall that during that base period, the building construction—and we are tied in with building construction in large part——

Senator CONNALLY. You prefer the alternative of an invested capital basis?

Mr. BROOKS. We are forced to use that, because the use of the average earnings base would be too expensive.

Senator CONNALLY. You advocate the raising of the percentages on all bases up to $5,000,000, is that right?

Mr. BROOKS. Yes, sir; that would help us if the percentages allowed on invested capital in those smaller brackets were adjustable.

Senator CONNALLY. That is your thought?

Mr. BROOKS. Yes; what we are suffering from is a lack of a suitable credit for excess profits as compared with most industries.

Senator CONNALLY. Of course, if you do not have any excess profits, you do not have to pay any excess-profits tax.

Mr. BROOKS. We have no excess profits in the true sense of an excess profit.

In other words, we are not making any excess profits out of the war. Our profit is entirely normal.

The CHAIRMAN. Your volume is increased, of course, on account of the war?

Mr. BROOKS. Yes.

The CHAIRMAN. Your profits ratio is lower?

Mr. BROOKS. Our profits ratio is lower.

Senator TAFT. What kind of stockholders do you have?

Mr. BROOKS. You would call it a close corporation.

Senator TAFT. What?

Mr. BROOKS. I think you would call it a close corporation.

Senator TAFT. You mean owned by a family, the members of a family?

Mr. BROOKS. Families or relatives, and many of the employees.

Senator TAFT. During the 4 base years presumably they got no dividends, practically?

Mr. BROOKS. That is right, they only had one.

Senator TAFT. They got on satisfactorily without the dividends? They are otherwise wealthy?

Mr. BROOKS. None would be called wealthy; a few are well off; most of them are not.

Senator CONNALLY. You mean to tell Senator George, though, that your volume is heavier now but you are making less money?

Mr. BROOKS. Yes, sir.

Senator CONNALLY. So the more business you do, the less well off you are?

Mr. BROOKS. We have had increases in material costs, we had many increases in labor costs, and our selling prices are the same.

Senator TAFT. You mean you would make less money after paying 83 percent in taxes?

Mr. BROOKS. We are making less money before taxes, and we are making substantially less after taxes.

Senator TAFT. If you makes less money before taxes, you haven't any excess profit to pay, I mean, more than in the base years.

Mr. BROOKS. Don't misunderstand me. I do not mean to say we are making less than in the 4 base years, I did not intend to say that.

Senator TAFT. Less than when?

Mr. BROOKS. Less than the year before, and the year before that; 1940 and 1941, definitely less than 1941 and 1940.

The CHAIRMAN. 1939 was one of your base years.

Mr. BROOKS. Yes, sir.

The CHAIRMAN. If your profits were going up during the last 2 years of the 2-base years you have some relief?

Mr. BROOKS. They are not adequate for our purposes.

The CHAIRMAN. It still leaves you in a position where you have no adequate credit against the excess profit.

Mr. BROOKS. Yes, sir.

The CHAIRMAN. And it puts a combined rate on everybody of 83 percent Federal taxes.

Mr. BROOKS. Yes, sir.

Senator TAFT. Of your invested capital, how much is new money that you put in since the war business developed?

Mr. BROOKS. We have not put in any additional capital since the war started.

Senator TAFT. I thought you said the expansion has been financed by the company with their own capital plus borrowing from local banks. You mean expansion during the recent years, that had nothing to do with the war?

Mr. BROOKS. No, no. It is a normal financing, without going out to get additional money, except by borrowing.

Senator TAFT. It occurs to me that the relief provisions in the bill might be applied. If your earnings in the base period for the industry was unduly depressed I should think maybe you could get relief from that.

Mr. BROOKS. I have not checked into that personally. I cannot answer that, because I am not familiar with that detail.

The CHAIRMAN. Thank you very much, Mr. Brooks.

Mr. BROOKS. Thank you, sir.

(A supplemental memorandum submitted by Mr. Brooks is on file with the clerk of the committee.)

The CHAIRMAN. Mr. Fisheles.

(No response.)

The CHAIRMAN. Mr. Hotchkiss.

STATEMENT OF C. F. HOTCHKISS, JR., PRESIDENT, STOW MANUFACTURING CO., BINGHAMTON, N. Y.

The CHAIRMAN. Mr. Hotchkiss, you represent the Stow Manufacturing Co., of Binghamton, N. Y.?

Mr. HOTCHKISS. Yes, sir. This is an amendment to a brief which we were too late to get before the House Ways and Means Committee, but we did hand it in at Mr. Stam's office.

My name is C. F. Hotchkiss, Jr. I am president of the Stow Manufacturing Co., of Binghamton, N. Y., incorporated under the laws of the State of New York.

I wish to present for your consideration certain facts concerning the excess-profits tax as it affects our corporation and other corporations in similar circumstances. I am also presenting a plan for correcting the inequities which will be explained later in this brief.

As I am not an accountant, I have brought with me Mr. W. E. Craw, assistant treasurer of our company, and Mr. J. J. Dawson, a New York certified public accountant, who acts as our accounting adviser. These gentlemen assisted in the preparation of this brief.

Would it be permissible for those gentlemen to come up here in case there are some questions that they know how to answer better than I?

The CHAIRMAN. Yes.

Mr. HOTCHKISS. Will you gentlemen step up, please?

The Stow Manufacturing Co. was established in 1875, and incorporated in 1895.

We manufacture flexible shafting and related products. Fundamentally, flexible shafting transmits portable rotary motion. It is used in portable tools, instruments on aircraft, automobiles, ships, and so forth, and remote control of valves and other devices. I have put a little sample in each copy of your brief, so you will get an idea of what we are talking about. Here is a larger size that we make for the Navy. I am not trying to sell flexible shafting, but I thought you would like to know what we are talking about.

Our customers include all types of manufacturers, practically all of whom are either prime or subcontractors to the Government. We also have a considerable volume of prime contracts with our Government, the Canadian, and Australian Governments.

Our peacetime products were mostly portable tools and speedometer core used in automobiles. This suffered greatly during the depression but we were making an orderly recovery during the base period of 1936 to 1939, although our profits during this period were very small.

Starting in 1938, we assisted the Ordnance Department in the development of a special flexible shafting for gun fire control. It was not until the year 1941 that any profit accrued from this development.

In the fall of 1941, at the request of the Navy Department, we developed a special flexible shaft for use on ships. By correcting a faulty condition on warships, we are not only saving many ships from disaster but we are saving the Government thousands of dollars on every ship that is built. The use of our product has speeded delivery of many ships to an appreciable extent.

The type of flexible shafting used for the Army and Navy has been made for many years by our company, by hand. Our production was very small, and entirely inadequate to meet the demand upon us by the Government. It was therefore necessary for us to invent and build special equipment to imitate the hand process formerly used. Frankly, we had to keep our fingers crossed for many months during the period when this equipment was being built and tested. However, this machinery was entirely satisfactory and at the present time it is turning out large quantities.

I might add, during that period we were being hounded by telephone and telegram by the Navy Department and other people for production. We were just making machines. I am happy to say it was worked out all right and we are working at full blast now.

Senator CONNALLY. You were helping yourselves when you invented that, as well as the Government; were you not?

Mr. HOTCHKISS. Yes, sir. We do not deny that. Our backlog of unfilled orders at the present moment is equivalent to 10 to 15 years of pre-war business. It is not unusual to receive orders representing 5 years of pre-war business in one mail. We got a little scared of those at first, but we are getting used to them now. Chart B, on page 12, if you care to pull that out, gives you an idea of our saleschart over the previous years. The expansion in sales you will notice is rather unusual, perhaps.

Naturally, this enormous expansion could not be accomplished without a tremendous increase in capital. Where were we to get this capital? We could not conscientiously seek outside investment because, due to the tax situation, dividends were out of the question. Also, we had an untried product, that is, for the purposes for which it was being sold, and we were asking considerably less for it. Advance payments on contracts were not practical because of the large number and variety of small contracts. In other words, we did not have one big contract, or we did not have all our products going to the same branch of the Government. There was not one prime contract, there were a great many subcontracts and prime contracts. So for us to try to get advance payments from the Government on the contracts we would have to hire 50 bookkeepers to keep the books straight, because you have to keep the costs separate for each contract. Also because of the haste in which deliveries were required. Deliveries are frequently made on basis of telephone instructions before official orders are even written. Under such conditions all available types of Government financing become impracticable.

After exhausting the resources of our local bank, we went to the R. F. C. for a loan which we obtained after pledging all contracts, control, and assets of the corporation. The amount of this loan is three times our invested capital. The loan was finally completed about 10 weeks after the start of negotiations

We will start paying off this loan in August at a rate of 20 percent of sales per month which is approximately our profit on sales before taxes. Since our taxes, under the proposed legislation, amount to 87 percent of our net income—I will explain that later—we can only pay off the loan by depleting cash which will be needed for taxes in March. Therefore, it will be necessary to negotiate new loans at that time. This condition will continue to pyramid until such a time as the demand for our products drops off, and if this should happen suddenly, we would find ourselves with enormous inventories, loans to pay off and a heavy tax liability, with no cash reserve. This constitutes an insolvent condition which might be further exaggerated by an honest difference in interpretation of the taxing statutes that would result in further assessments of taxes at a later date. Such an assessment could prove disastrous.

To illustrate that point on the difference of opinion, supposing, for instance, we just built an engineering department in an old building, we took a section of it that was not being used and fixed it up for engineers and we charged it to repairs: Now, the tax department might not agree with us on that. Later we might be assessed taxes at a time when we could not afford to pay them, and we might go bankrupt at that time. That particular thing

might not be enough, but if you had an accumulation of them it might. I do not mean to say we are taking a lot of liberties with exemptions, but such a thing might be possible when you are working on such a close margin.

To take care of our increased business it was necessary during 1941 and 1942 to spend about $80,000 on additional buildings and machinery, which, of course, are all capitalized. This was only enough to take care of actual expansion at the time the buildings were built. We would like to have built the buildings large enough to take care of our additional anticipated expansion. However, we were afraid that we might go bankrupt in the process, due to the heavy taxes.

It is true that there is a certain amount of relief to be obtained under a certificate of necessity, allowing new capital equipment to be depreciated over a 5-year period rather than the normal life of the equipment. Actually this is more figurative than literal, as these capital items are used or operated in most instances at three times their normal rate. Due to the pressure under which everyone is working, it is impossible to give these machines proper maintenance. They are pretty well shot probably by the end of the 5 years.

We realize that the proposed House bill contains provision for relief for which we might apply. However, these measures are not specific and are subject to the judgment of the reviewing body. Furthermore, much time would elapse in the review of our case and the probabilities of relief could not be used as collateral at a bank. The House bill proposes to allow the taxpayer to pay only 67 percent of the tax on which he is requestiong relief, but this does not relieve the taxpayer of any anxiety he may have over the possible results of his appeal, nor can he plan for the future with any assurance of having money with which to do business. We believe that the law should give clear-cut relief to corporations in similar circumstances to ours, thus removing a considerable group from asking relief, and giving the said group the opportunity of devoting its entire attention to operating, rather than survival.

I do not know just how these reviewing boards will be set up, but I presume there will be a great many companies asking for relief. Certainly practically all companies in the same circumstances as we are will ask for relief.

Senator CONNALLY. Let me ask you a question on that.

Mr. HOTCHKISS. Yes.

Senator CONNALLY. What proportion of your business has been taken over by the Army and Navy?

Mr. HOTCHKISS. Probably 99.8 percent.

Senator CONNALLY. 99.8 percent of your business is going to the Government?

Mr. HOTCHKISS. Yes, sir.

Senator CONNALLY. Do you make other things besides this shafting.

Mr. HOTCHKISS. It is all related to the shafting.

For your information, I have put a couple of pieces of our literature in the back, which gives you an idea of our products. I thought you might be interested.

Senator TAFT. Are the new products going to be produced after the war, in civil life?

Mr. HOTCHKISS. We hope so. We hope we can get the shipyards and other people sufficiently flexible-shaft minded so we can maintain a pay roll similar to our present pay roll after the war, although there certainly will be a year or two of readjustment, during which time we have got to watch our p's and q's or we will go broke.

Senator TAFT. I should think even if you could sell your new products the volume would be considerably smaller.

Mr. HOTCHKISS. Undoubtedly.

Senator TAFT. After all, there are not likely to be so many ships built.

Mr. HOTCHKISS. Undoubtedly.

Senator CONNALLY. Are you the principal maker of this product in the United States?

Mr. HOTCHKISS. We have a few competitors. As far as I know, we are the only ones capable of making this particular shafting.

Senator CONNALLY. Then your contracts with the War and Navy Departments are mostly negotiated?

Mr. HOTCHKISS. No, sir; they are all straight bid contracts.

Senator CONNALLY. If nobody else can make the product except you it does not present a question of competition in bidding, does it?

Mr. HOTCHKISS. No; we get our price. We are not complaining. As I mentioned before, we have been making a net profit, before taxes, of about 20 percent, on the present volume of sales. Naturally, our overhead has gone up, but it has not gone up as fast as sales.

Senator CONNALLY. You mean you have made a net profit of 20 percent?

Mr. HOTCHKISS. That is right.

Senator CONNALLY. That is pretty fair.

Mr. HOTCHKISS. We are not complaining about that. As a matter of fact that 20 percent is pretty near necessary in order to have money to do business with and maintain an enormous inventory, which we are asked to maintain.

Senator TAFT. Is it necessary to have a net profit of 20 percent to pay on the loan?

Mr. HOTCHKISS. That is true. We are paying 20-percent profits on our sales during the life of the loan. We have got to make another loan when this one is finished, and we are going to have to take all the profits to pay it back. During the same period we are increasing business. The darned business doubles every 2 or 3 days. We cannot keep track of it, hardly. All we are looking for is survival.

Senator CONNALLY. If they just let you alone you will be all right.

Mr. HOTCHKISS. Yes, sir. We have no definite statistics to show the number of concerns in similar circumstances to ours. We believe there may be a thousand firms in the entire country.

We are making a guess at about 1,000 firms. Possibly that is high and possibly that is low. We happen to have one customer that we know is just about in the same boat as we are. They buy flexible shafting from us and make a product that is used for drilling airplane parts, or drilling wings on airplanes, and so forth, and they have had about a similar condition to ours.

To define such corporations, they must be subject to the following three conditions:

1. The company must have very small capitalization.
2. The ratio of this capitalization to sales must be extremely low.
3. Base-period earnings must be so small as to render no relief for the present financial problem.

We submit, as schedule A, a calculation of our estimated taxes for 1942 based on the proposed tax legislation as passed by the House of Representatives.

That is, we are guessing at $2,000,000 sales. Twenty percent of it would be $400,000. We pay a total tax of $347,000, leaving us $52,924 to do business on.

Based on reasonably accurate available statistics, we find the following examples show our comparable position in relation to excess-profits taxes under the proposed law as compared to other businesses as illustrated in chart A. As illustrated in chart D—frankly, I stole that from Mr. Davidson; I tried to get his permission, but I could not get hold of him, so he can put me in jail if he sees fit—you will find we are able to retain 13 percent as against 18 percent for the aircraft industry, which is supposed to be the hardest hit, and so on down. I included that in the brief here.

1. Industries that might be classed as exclusively "war industries" range from 26 percent of total profits subject to excess-profits tax in the motor-vehicle industry, up to 82 percent subject to such tax in the aircraft-manufacturing group. This means that the motor-vehicle industry can retain 43.3 percent of its entire taxable income, while the aircraft-manufacturing group, which, however, is almost completely Government financed, may retain 18.1 percent of its entire taxable income.

2. Industries that might be readily classed as essential normal industries show percentages of total incomes subject to excess-profits taxes ranging from 12 percent in public utilities, up to 63 percent in pulp and paper. Which means that the public-utilities group may retain 50 percent of its entire taxable income, while the pulp and paper industry may retain 27 percent of its entire taxable income.

3. A fair weighted average of the first group, namely, the "war industries," would indicate that they may retain 32½ percent of their net taxable income, while the second group on a weighted-average basis would be permitted to retain approximately 35 percent of income.

4. Our business under the proposed tax legislation shows a percentage of earnings subject to excess-profits taxes of approximately 93 percent of the total taxable income, which means that we will be permitted to retain 13 percent of our entire income. That is compared with the 18.1 percent for the aircraft or 50 percent for utilities.

We have a plan which incorporates a theory of relief that is based on the following tax philosophy:

1. We believe it to be the thought of tax-devising agencies that no individual or corporation is entitled to become permanently enhanced in worth as the result of war income. We subscribe to this theory.

2. Industries such as ours represent a new tax-producing factor. Unless such factors are encouraged to continue in business as a continued source for taxable income, future taxing statutes will lose the benefit of such income.

3. Both the Treasury proposals and the Ways and Means Committee proposals for new tax legislation apparently have no intent of imposing on industry the prohibitive rates to which our corporation will be subjected.

We believe that the two alternate methods for excess-profits tax credit contained in the existing statute are sound for many corporations. Certainly, the investment method is sound where a normal

relation of capital to income exists, and likewise the earnings method is sound where going concerns have enjoyed reasonable normal and continued profits. We feel, however, that the two existing methods should be supplemented with a third method and the taxpayer be given the option of using that which would result in the least tax in his specific case. Therefore, we propose: That a blank exemption from excess-profits tax be established and that said blanket exemption be increased in a fixed sum for established increases in volume of sales over the sales during the basic period from 1936 to 1939, inclusive, and that such exemption be allowed as a third optional excess-profits tax credit.

We submit schedule B as a basis for such a blanket credit.

Based on estimated earnings for 1942, such a blanket credit would permit our corporation to retain 80 percent of its total net income as compared with 32½ percent to be retained by war industries under the present statute, and 35 percent for essential normal industries under the present statute.

This proposal will only affect corporations in similar circumstances to ours. And we present schedule C to substantiate this.

If we assume that a corporation has an invested capital of $5,000,000—understand I am interested in small corporations—and an average earning during the base period of $300,000, then the credit under the invested-capital method now in effect, 8 percent of $5,000,000, plus $10,000, would give them $410,000 exemption. By the average-earnings method they get $310,000, and by our suggested method they would only get $180,000. I do not think I have gone sufficiently into our schedule here. You notice we started out at 50 percent and allowed $10,000 additional exemption. Then, if they have increased their business 100 percent we allow them an additional $10,000, which gives them a total of $30,000 exemption. For 300 percent we allow an additional $18,000 exemption. In other words, we have got specific amounts of exemption, so it does not help the big fellow. In other words, if it were in percentages rather than fixed amounts, then you would find some of the big corporations would be able to benefit by it because their earnings would go up on a percentage basis instead of on a fixed-amount basis. In other words, in order for a large corporation, or for any corporation, to benefit from the proposed plan, the sales would have to increase 3,600 percent; that is, for this $5,000,000 corporation.

Since the above case is predicated on but 6 percent earnings on invested capital during the base period, said base period earnings would have to be 2.8 percent of capital or less before any benefit would accrue.

Should we increase the hypothetical earnings as to percentage of invested capital, then the earnings method credit would be greater and no advantage would result from the proposed plan.

In order for such a corporation to benefit from the proposed plan as against the invested capital method the invested capital would have to be $1,750,000 or less if sales increased 1,000 percent over the base period. A lower percentage of increase in sales over the base period would continue to make the invested capital method most beneficial.

After giving effect to our proposed schedules and using the same corporate figures used in schedule A, we submit schedule D, also chart

C, which shows our relative position under the proposed House bill and our plan. Have you any questions?

The CHAIRMAN. Are there any questions, Senator Connally?

Senator CONNALLY. No.

The CHAIRMAN. Do you desire to file your brief?

Mr. HOTCHKISS. Yes, sir.

The CHAIRMAN. You have followed it fairly closely, but you may file it.

Is there any additional statement that either of the gentlemen who are with you care to make?

Mr. HOTCHKISS. Mr. Dawson.

Mr. DAWSON. I haven't anything particularly of importance, except to explain the 20 percent. Mr. Hotchkiss mentioned 20 percent net before taxes and 13 percent after, which would mean 2.6 percent on sales is all the corporation would be able to retain. It is not enough to take care of the expansion. They paid no dividends over a period of years either.

Senator CONNALLY. That is before the tax was put on?

Mr. DAWSON. That is very true, but now they have to pay for the commitments that they made during the subsequent years. After all, they had to spend a lot of money to increase the capacity 1,400 percent.

Mr. HOTCHKISS. Incidentally, we have no anticipation of paying dividends at the present time.

Senator CONNALLY. You are accumulating in plant, though?

Mr. HOTCHKISS. I do not deny that our plant is in better shape. It needed quite a few repairs, and it has been able to get them. Nevertheless, we are doing exactly what they want us to do.

Senator CONNALLY. That is fine. I congratulate you.

Mr. HOTCHKISS. The more we expand the more we try to help on the war effort the further we are sticking our neck out, because our profits will all be represented in inventory and accounts receivable.

The CHAIRMAN. What is your loan with the R. F. C.?

Mr. HOTCHKISS. $300,000.

Senator CONNALLY. Thank you.

Mr. HOTCHKISS. Thank you, sir.

(The schedules and charts submitted by Mr. Hotchkiss are as follows:)

SCHEDULE A

Proposed House legislation

Estimated net income		$400,000
Investment method:[1]		
8 percent of $134,000	$10,720	
Average loans, $100,000	8,000	
Specific exemption	10,000	
Total exemption		28,720
Balance subject to excess-profits tax		371,280
Excess-profits tax, 90 percent of $371,280		334,152
Normal tax, 45 percent of $28,720		12,924
Total taxes		347,076
Net profit after taxes		52,924

[1] Earnings method results in lower credit.

SCHEDULE B

Proposed blanket exemption method

Increase in sales over base period 1936-39 (percent)	Additional exemption	Exemption	Increase in sales over base period 1936-39 (percent)	Additional exemption	Exemption
0	0	$10,000	600	$10,000	$100,000
50	$10,000	20,000	700	10,000	110,000
100	10,000	30,000	800	10,000	120,000
200	18,000	48,000	900	10,000	130,000
300	16,000	64,000	1,000	10,000	140,000
400	14,000	78,000	Above 1,000		[1] 10,000
500	12,000	90,000			

[1] Per 100 percent.

SCHEDULE C

Let us assume that a corporation has an invested capital of $5,000,000 and an average earning during the base period of $300,000—

Then:

Credit under invested capital method (now in effect) 8 percent of $5,000,000 plus $10,000	$410,000
Credit under earnings method (now in effect)	310,000
Credit under additional proposed method (assuming even that sales have increased 1,400 percent)	180,000

Such a corporation would exercise the option of using the invested capital method.

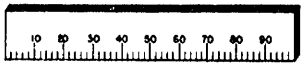
COMMENTS

1. In order for such a corporation to benefit from the proposed plan, sales would have to increase at least 3,600 percent over the base period sales.
2. Since the above case is predicated on but 6 percent earnings on invested capital during the base period, said base period earnings would have to be 2.8 percent of capital or less before any benefit would accrue.
3. Should we increase the hypothetical earnings as to percentage of invested capital, then the earnings method credit would be greater and no advantage would result from the proposed plan.
4. In order for such a corporation to benefit from the proposed plan as against the invested capital method the invested capital would have to be $1,750,000 or less if sales increased 1,000 percent over the base period. A lower percentage of increase in sales over the base period would continue to make the invested capital method most beneficial.

SCHEDULE D

Sales, base-period average		$144,000
Estimted sales 1942		2,000,000
Increase (percent)		1,400
Exemption proposed plan		180,000
Estimated net income	$400,000	400,000
Excess-profits tax credit	180,000	
Income subject to excess-profits tax	220,000	
Excess-profits tax	198,000	
Income subject to normal tax, $180,000.		
Normal tax, 45 percent	81,000	
Total normal and excess-profits taxes		279,000
Total net profit after taxes		121,000

RELATED DWGS.



WAR IND.

Stow Mfg. Co.	13 %
Aircraft Mfg.	18 %
Electrical Equip	25 %
Industrial Equip	26 %
Chemical	27 %
Railroad Equip.	29 %
Steel	31 %
Shipbuilding	36 %
Motor Vehicles	43.3 %

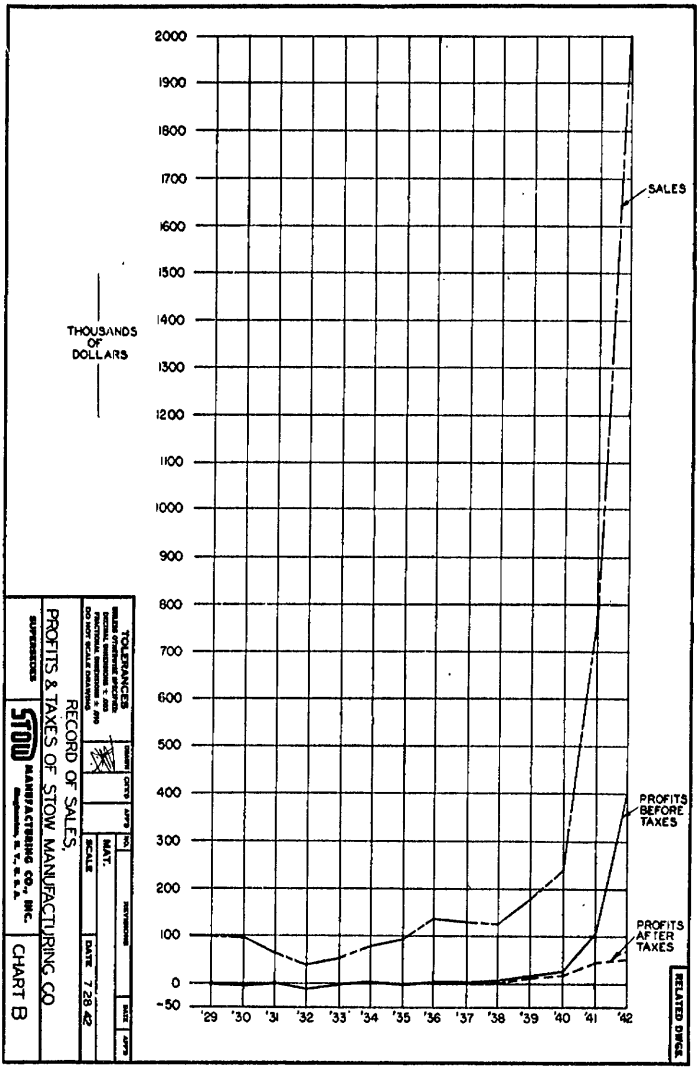
ESSENTIAL NORMAL IND.

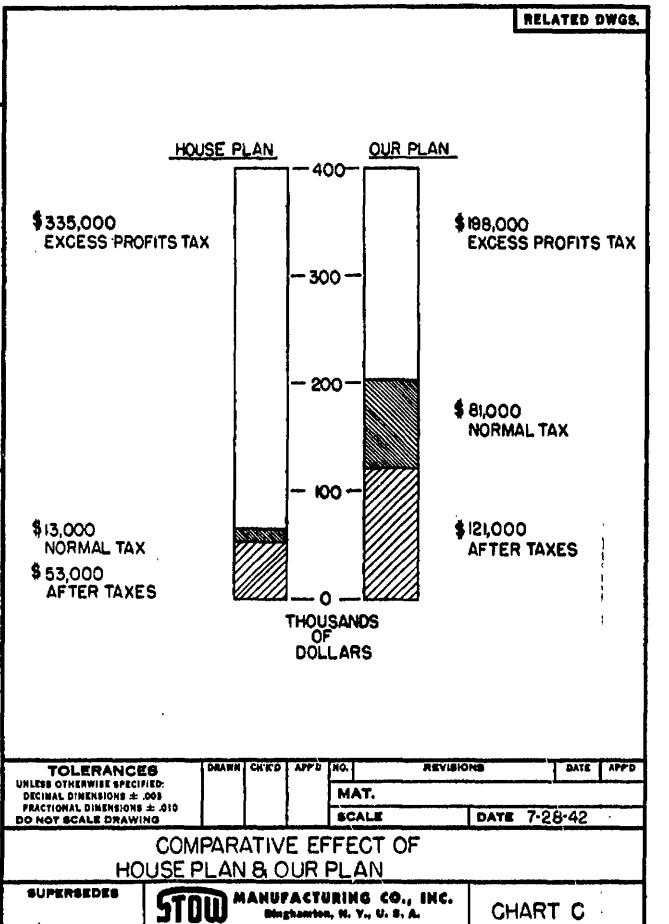
Paper & Pulp	26 %
Hd'ware & Tools	27 %
Prtg. & Publishg	33.4 %
Retail Trade	36 %
Container	37 %
Petroleum	40.15 %
Liquor	41.5 %
Food	42 %
Cigarette Mfg.	43.3 %
Med.,Drug,Soap	46.5 %
Tel. & Tel.	49.25 %
Elec. Pr. & Lt.	50 %

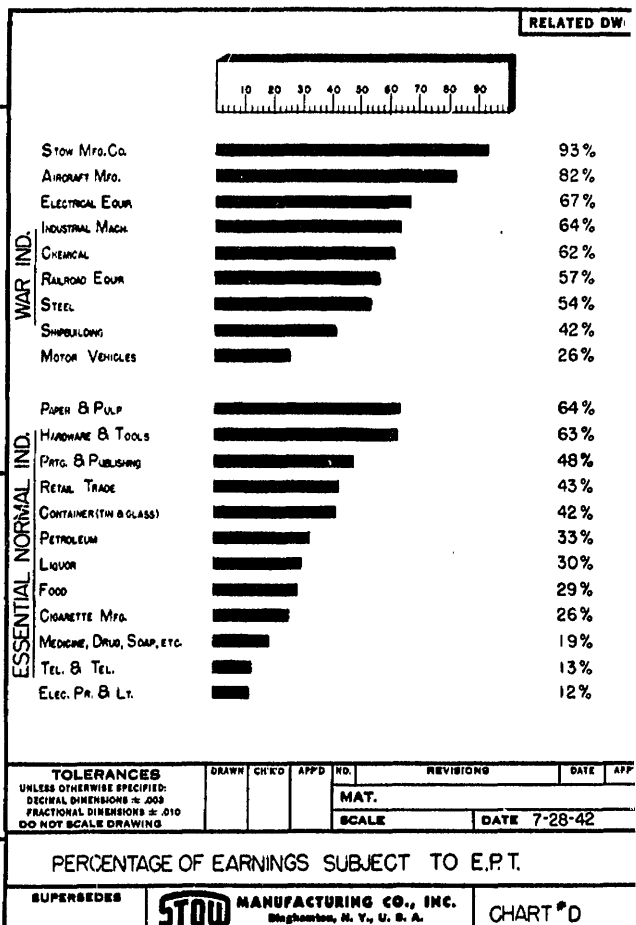
TOLERANCES	DRAWN	CH'K'D	APP'D	NO.	REVISIONS	DATE	APP'D
UNLESS OTHERWISE SPECIFIED: DECIMAL DIMENSIONS ± .003 FRACTIONAL DIMENSIONS ± .010 DO NOT SCALE DRAWING					MAT.		
					SCALE	DATE 7-28-42	

PER CENT OF PROFITS RETAINED AFTER TAXES

SUPERSEDES	STOW MANUFACTURING CO., INC. Binghamton, N. Y., U. S. A.	CHART A


2000
1900
1800
1700
1600
1500
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
-50
THOUSANDS OF DOLLARS
'29 '30 '31 '32 '33 '34 '35 '36 '37 '38 '39 '40 '41 '42
SALES
PROFITS BEFORE TAXES
PROFITS AFTER TAXES
RELATED DWGS.
RECORD OF SALES,
PROFITS & TAXES OF STOW MANUFACTURING CO.
CHART B
STOW MANUFACTURING CO., INC.
SUPERSEDES
TOLERANCES
DRAWN
CHKD
APPD
NO.
REVISIONS
MAT'L
SCALE
DATE 7-28-42
DATE
APPD


RELATED DWGS.
HOUSE PLAN
OUR PLAN
400
300
200
100
0
$335,000
EXCESS PROFITS TAX
$198,000
EXCESS PROFITS TAX
$81,000
NORMAL TAX
$13,000
NORMAL TAX
$53,000
AFTER TAXES
$121,000
AFTER TAXES
THOUSANDS
OF
DOLLARS
TOLERANCES
UNLESS OTHERWISE SPECIFIED:
DECIMAL DIMENSIONS ± .003
FRACTIONAL DIMENSIONS ± .010
DO NOT SCALE DRAWING
DRAWN
CH'K'D
APP'D
NO.
REVISIONS
DATE
APP'D
MAT.
SCALE
DATE 7-28-42
COMPARATIVE EFFECT OF
HOUSE PLAN & OUR PLAN
SUPERSEDES
STOW MANUFACTURING CO., INC.
Binghamton, N. Y., U. S. A.
CHART C


RELATED DW
10 20 30 40 50 60 70 80 90
WAR IND.
STOW MFG. CO. 93%
AIRCRAFT MFG. 82%
ELECTRICAL EQUIP. 67%
INDUSTRIAL MACH. 64%
CHEMICAL 62%
RAILROAD EQUIP. 57%
STEEL 54%
SHIPBUILDING 42%
MOTOR VEHICLES 26%
ESSENTIAL NORMAL IND.
PAPER & PULP 64%
HARDWARE & TOOLS 63%
PTG. & PUBLISHING 48%
RETAIL TRADE 43%
CONTAINER (TIN & GLASS) 42%
PETROLEUM 33%
LIQUOR 30%
FOOD 29%
CIGARETTE MFG. 26%
MEDICINE, DRUG, SOAP, ETC. 19%
TEL. & TEL. 13%
ELEC. PR. & LT. 12%
TOLERANCES
UNLESS OTHERWISE SPECIFIED:
DECIMAL DIMENSIONS ± .003
FRACTIONAL DIMENSIONS ± .010
DO NOT SCALE DRAWING
DRAWN
CH'K'D
APP'D
NO.
REVISIONS
DATE
APP
MAT.
SCALE
DATE 7-28-42
PERCENTAGE OF EARNINGS SUBJECT TO E.P.T.
SUPERSEDES
STOW MANUFACTURING CO., INC.
Binghamton, N. Y., U. S. A.
CHART "D"

(The following supplementary brief and chart was submitted by Mr. Hotchkiss:)

SUPPLEMENTARY BRIEF OF C. F. HOTCHKISS, JR., PRESIDENT OF STOW MANUFACTURING CO., BINGHAMTON, N. Y.

In our original brief we established the necessity for a plan to relieve corporations such as ours from the disastrous effects of the excess-profits tax as passed by the House of Representatives. We offered a plan. We think the plan a good one and we believe it will work. However, our plan is restricted to relatively small corporations with recent abnormal growth.

Therefore, we present an alternative plan which we feel could be used as a simple over-all formula to protect all corporations from excessive and ruinous taxation.

ALTERNATIVE PLAN

Combined normal tax, surtax, and excess-profits tax on any corporation should be subject to a ceiling of not more than 70 percent of its taxable income.

The essence of our formula is simplicity.

We do not advocate a lower rate of excess-profits tax.

We do not advocate a lower normal or surtax rate.

We do advocate a limit to the amount of total taxes.

The small loss of revenue caused by the ceiling could be easily recovered by a very slight increase in the rates of either normal or excess-profits tax.

The ceiling idea is elastic. The ceiling may be raised or lowered as experience dictates.

The principle of a ceiling in taxation reduces the necessity of liquidating inventories and equipment, or borrowing to pay taxes. Practically all profits are represented by inventories rather than cash.

With a ceiling, the Congress need not be concerned about how high it made the tax rates.

Our plan makes the possibility of taxing corporations into bankruptcy remote.

The all-important job is to win the war. Taxation should not be a damper on war production.

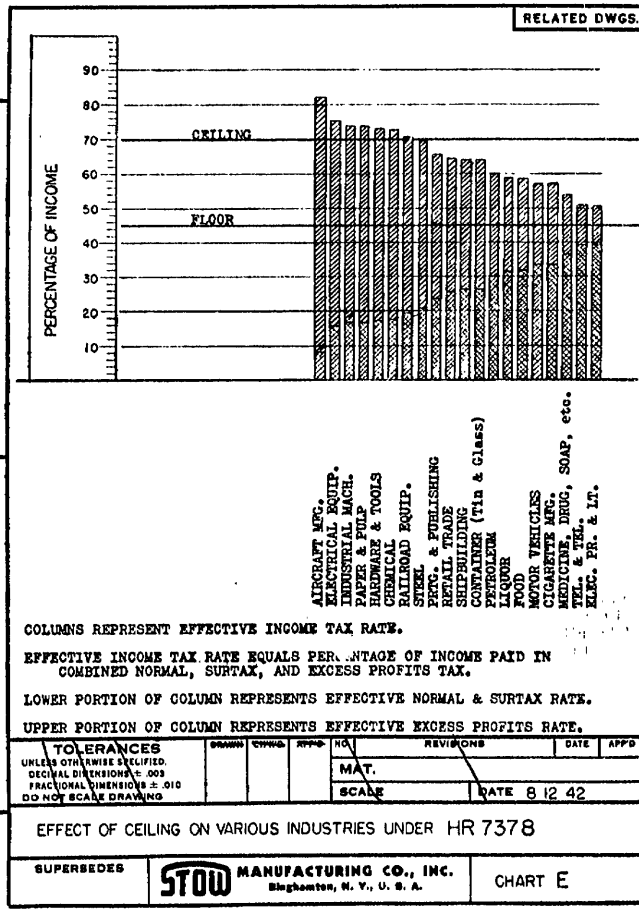
Post-war relief is not the answer. Small corporations need help now to carry on war production to the fullest extent. Therefore, any plan of post-war relief would be too late to be of any help in winning the war. Post-war relief locks the barn after the horse has been stolen.

Patriotic concerns are more concerned with their ability to stay in business and continue the war effort than they are with pecuniary gain.

The attached chart illustrates our plan.

Respectfully submitted,

C. F. HOTCHKISS, Jr., *President.*


RELATED DWGS.
PERCENTAGE OF INCOME
90
80
70
60
50
40
30
20
10
CEILING
FLOOR
AIRCRAFT MFG.
ELECTRICAL EQUIP.
INDUSTRIAL MACH.
PAPER & PULP
HARDWARE & TOOLS
CHEMICAL EQUIP.
RAILROAD EQUIP.
STEEL
PETRO. & FUELISHING
RETAIL TRADE
SHIPBUILDING
CONTAINER (Tin & Glass)
PETROLEUM
LIQUOR
FOOD
MOTOR VEHICLES
CIGARETTE MFG.
MEDICINE, DRUG, SOAP, etc.
TEL. & TEL.
ELEC. PR. & LT.
COLUMNS REPRESENT EFFECTIVE INCOME TAX RATE.
EFFECTIVE INCOME TAX RATE EQUALS PERCENTAGE OF INCOME PAID IN COMBINED NORMAL, SURTAX, AND EXCESS PROFITS TAX.
LOWER PORTION OF COLUMN REPRESENTS EFFECTIVE NORMAL & SURTAX RATE.
UPPER PORTION OF COLUMN REPRESENTS EFFECTIVE EXCESS PROFITS RATE.
TOLERANCES
UNLESS OTHERWISE SPECIFIED.
DECIMAL DIMENSIONS ± .003
FRACTIONAL DIMENSIONS ± .010
DO NOT SCALE DRAWING
DRAWN
CHKD.
APP'D
NO.
REVISIONS
DATE
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MAT.
SCALE
DATE 8 12 42
EFFECT OF CEILING ON VARIOUS INDUSTRIES UNDER HR 7378
SUPERSEDES
STOW MANUFACTURING CO., INC.
Binghamton, N. Y., U. S. A.
CHART E

The CHAIRMAN. Mr. Robineau.

STATEMENT OF M. H. ROBINEAU, PRESIDENT, FRONTIER REFINING CO., CHEYENNE, WYO.

Mr. ROBINEAU. Mr. Chairman and gentlemen of the committee, I am the president and general manager of the Frontier Refining Co., a small corporation organized under the laws of Wyoming. We are in the business of operating a refinery; we make petroleum products at Cheyenne, Wyo., and operate a few service stations. We come in the class of a small corporation.

Senator GUFFEY. Do you produce your own oil, or buy oil?

Mr. ROBINEAU. We buy oil from the field.

I am also appearing here to speak for two other small oil companies, the Minnelusa Oil Corporation, of Denver, Colo., and the Perry Petroleum Co., of Denver.

I would like the committee to feel, while I am not authorized to speak for others, I do make my plea for the many small corporations with contractual obligations who I am sure will be affected all over the country by the proposed bill from the House Ways and Means Committee.

I would like to use our company as an example of what we feel works an undue hardship.

Our company was formed in June 1940. At that time we acquired part of the properties of a predecessor corporation. Those particular properties had a good earning record during the base period, but because of our method of acquiring, we are not permitted to use the average earnings base and we have to go on the invested-capital base.

Our invested-capital base, because we took the properties over at their book value, is low, approximately $100,000. This has worked an undue hardship on us. I have been reading the general relief provisions in the proposed bill. It is possible that we may be able to get some relief, we may be able to qualify for relief under this abnormally low invested-capital base, but the way these relief provisions are worded, there is no yardstick to determine whether we can or cannot get relief, or what the relief will be, and we are placed, you might say, at the mercy of the Commissioner, or the Board of Tax Appeals, and we might be involved in serious and expensive litigation for many years, and during that period, our contractual obligations must be paid on the due date.

In other words, companies in our situation might conceivably go broke while appealing for relief.

Our company, during the fiscal year—we operate on a fiscal-year basis, which ends May 31—during the fiscal year which has just ended, we made $180,000 net profit, before Federal income and excess-profits taxes.

Based on the existing law, our normal and surtax total approximates $35,000, and our excess-profits tax totals $68,000, or a total of $103,000. If the present retroactive clause for a fiscal corporation goes into effect in the final bill, that $103,000 will be raised to $121,000.

Based on $103,000, that still leaves us from $180,000, $77,000, which permits us to make our debt payments and still have something left

for plant improvements and to maintain our working capital position.

I might state, at this point, when we formed this company in 1940, the properties we took over were not a complete modern operating unit. At the time we formed the company, we knew we would have to add improvements, specifically, the addition of a cracking plant, thermal cracking unit which would cost us approximately $200,000.

In order to make these improvements, we borrowed $175,000 on 5-year serial bonds which mature at the rate of $35,000 during this present fiscal year and $40,000 a year thereafter.

Under the existing law, for last year we came out all right. We do not have anything left for dividends. We will not be able to pay any dividends, but at least we can pay our debt, and we can make the necessary plant improvements, which, in an operation of our size, has run during the last 2 years at approximately $40,000 to $45,000 a year.

Those are plant improvements which we cannot charge off to maintenance under the internal-revenue regulations.

Under this proposed law, assuming we can make $180,000 again in this coming year, which I do not think, in this particular year we can, because, in our business, in our oil business, we have ceilings on our selling prices and the consumption has gone down because of the tire situation and other reasons, yet the costs of our operation have gone up because we have had several wage increases, and we are probably faced with some further wage increases—assuming we did make $180,000 in the next year, under the present proposed law, our taxes, the normal surtax and excess-profits tax, as we figure it, will run $145,300.

Deducting that from $180,000 leaves us $34,700, which is barely enough to pay our debt maturity of $35,000. Even counting on the depreciation reserve we can set up, we cannot have enough cash left over to take care of normal plant improvements or to maintain our working-capital position.

In our particular instance, there may or may not be a sufficient cash reserve to carry us through for some period of time, but no company, no matter how large, can stand a continual drain on its cash. Therefore, unless we can get relief, we are quite likely to go broke.

Either one of two things could happen: We could be forced into the hands of a creditors' committee, or we would be forced to sell out to a large oil company. I do not think that either one of these alternatives are desirable to anyone. They are certainly not desirable to companies such as ours.

I do not believe they are desirable to the community, because I believe each of you gentlemen can think in your own communities of two or three companies similar to ours that are of value to that community. They have the opportunity to be of more value than the branch offices of large companies, because they are more interested in the community life; they have usually larger pay rolls in that particular area.

I am sure everyone in the community will suffer, either directly or indirectly, if a corporation such as ours is forced out of business. I am sure the Government will lose taxes if that happens.

I cannot conceive that companies operating under creditors' committees can pay as much taxes as we can pay, if maintained as a going concern.

I do not believe, if we were forced to sell out, or if companies like us were forced to sell out to larger oil companies, with branch-office operations in those particular communities, they would pay as large taxes, or the total entity would pay as large taxes, because the large corporations are well capitalized by the public, are capitalized on an earnings basis and can only expect to make 4 or 5 percent on their invested capital, and they usually have losses, or they have a large enough base so that they can absorb mergers, the companies bought such as ours and not pay the high percentage of tax that we will pay and are willing to pay if we are permitted to exist.

The CHAIRMAN. What do you propose?

Mr. ROBINEAU. I propose that there be some sort of provision for relief of contractual debt, a debt which is a bona fide debt, which was in existence way before January 1, 1942, when this current law was being enacted.

I realize that the Government must have some protection. This means a reduction of some revenue, although I do not think they would be major reductions. These are all small corporations.

We are talking about small money. While it may add up to two or three million dollars, yet, in proportion to the whole bill, it is not a major thing.

The Government would want certain restrictions. I am not a tax expert. I only know how I am hurt by this particular law.

I suggest you may have one limitation that could be put in, that exemptions under the excess-profits law should not exceed, say, the total sum of $100,000 a year or $50,000.

Senator DANAHER. How about a percentage of the outstanding debt?

Mr. ROBINEAU. Say not over one-fourth of the outstanding debt, something like that, or, in the alternative, it shall not be more than the actual contractual payment which is due in that year. In other words, because we had relief, we could not anticipate.

Senator CONNALLY. You would only get relief in the event you retired the debt.

Mr. ROBINEAU. That is right, only relief on actual payment of the debt.

The CHAIRMAN. You would have to have a percentage of your real income, that is, the percentage of your earnings used in computing your net income just the same.

Mr. ROBINEAU. It seems to me there would have to be some percentage.

Senator GUFFEY. Mr. Robineau, how many barrels a day do you refine?

Mr. ROBINEAU. We refine 1,500 barrels a day.

Senator GUFFEY. 365 days a year?

Mr. ROBINEAU. No. Our actual stream time may be probably 300 days a year.

Senator JOHNSON. As you add to your capital investment, are not you able to make investments?

Mr. ROBINEAU. Not in proportion to the earnings we made. We happen to have an abnormally low capital base.

Senator JOHNSON. You said because you purchased the company at its book value, you have a low capital base. Did you pay more than $100,000 for the company?

Mr. ROBINEAU. I would probably have to explain it, how we acquired the company, to show why this is an abnormally low invested capital base.

I was formerly an officer and stockholder in the predecessor company, from whom we acquired the properties as the result of a lawsuit, and in settlement of the various difficulties, these properties were divided, so I received the properties.

So, my invested base, or our invested base, because we have other stockholders besides myself, goes back to the original investment in the predecessor company, you see, back in 1924 or 1925, which was $100,000.

I did not get the benefit of the earnings that these particular properties made during the base period because we are not considered a tax-free reorganization.

The CHAIRMAN. I understand that.

You only had a tax base of $100,000 plus, of course, the amount of your borrowed money for capitalization purposes.

Mr. ROBINEAU. Yes; we have that.

The CHAIRMAN. I think we understand your situation.

Mr. ROBINEAU. I would like to also make this plea, that in your relief provisions, either they be clarified in some way so that companies, such as ours can be sure we can get relief, or some definite yardstick, or some definite statement of how the relief we can get will be worked into the bill, so we would not be in the position of trying to get relief based on our investment capital basis, being abnormally low, and we would be in the courts for years to get this relief.

Senator GUFFEY. What does your oil cost delivered to the refinery?

Mr. ROBINEAU. It costs us $1.37 per barrel.

Senator GUFFEY. You must have a very economic refinery or have a very good sales organization. According to your own figures, you make 40 cents a barrel.

Mr. ROBINEAU. We operate in what is known as a high differential area. We have the low cost of crude as compared to the sales price we receive for our merchandise.

The CHAIRMAN. Thank you, very much.

Mr. Spence.

STATEMENT OF PAULSEN SPENCE, REPRESENTING SPENCE ENGINEERING CO., INC., WALDEN, N. Y.

Mr. SPENCE. Mr. Chairman and members of the committee, in following these proceedings this morning, I have little to add to what has been said; for instance, by Mr. Hotchkiss and the other two gentlemen ahead of me, but it seems to me that the Congress, in general, in the procedings this morning, have overlooked the essential point.

Now, as far as I am personally concerned, I am not asking for any relief, because I have my statement here and it shows that I am sitting pretty, but I have a plant which is, at present, producing about $500,000 worth of essential war materials a year.

That plant is capable of turning out a million and a half dollars worth of essential war material. Now, under the proposed tax law, as

it now stands, I haven't got enough money to finance that much business, and it would seem to me that the essential point that you gentlemen should consider is: Do you want to collect taxes or do you want to get out war production?

Senator CONNALLY. I do not think we can get out war production without any taxes, do you?

Mr. SPENCE. Well, you can do both. There is an economic term that is known as the law of diminishing returns.

Senator CONNALLY. I have heard of that.

Mr. SPENCE. Now, if you tax me less so I could keep some of that money to use to finance this increased business, you would actually collect more dollars. That is the thing that you want to remember.

Now, the next thing to consider is that when the war is won, we still want to keep collecting taxes, and certainly, you do not want to put these small corporations in a position where they cannot keep on doing business.

Now, the cost of the war will have to be paid, and the cost of the war can only be paid by prosperous business. Now, my contention and what I suggest to the committee is this: On a small corporation—and I call a small corporation one that has an invested capital of less than a million dollars—I do not think you should try to collect more than 20 or 30 percent total taxes; if you do that, you are going to get more employment, and you will collect more taxes, not only from the corporations but from the stockholders and their employees.

So that the Treasury is going to get more dollars in the end, and we are going to have more income left to improve our companies with.

Senator CONNALLY. What do you make?

Mr. SPENCE. Pressure-reducing valves. They have to be installed before the plant will run.

One reason I wish to apologize for not having a prepared brief, I have been too busy trying to get a couple of war plants started to get to a stenographer.

I would like to be questioned, Senator, about the points that I have raised.

You have been questioning these other people, now you may question me.

Senator CONNALLY. All right. What are you in such a terrible hurry to get these two war plants started for, if you cannot make any money out of them?

Mr. SPENCE. Because I am patriotic. I happened to have been born and raised in Louisiana. If I went by dollars and cents only, the only thing for me to do is sell my plants and invest my money in municipal bonds and go back to Louisiana and cat-fishing. The only reason I do not do that is because I am patriotic.

Senator CONNALLY. We congratulate you.

Mr. SPENCE. We can do more if you let us, but if you will look at my statement here, and see how I am going to pay my taxes and finance the inventory that I have to carry in order to do business, well, then the cigar is on me.

Senator CONNALLY. How much mortgage do you have?

Mr. SPENCE. I have a small note at the bank to cover two turret lathes. If I have to operate under the proposed law, I will not have enough cash left to pay for the two turret lathes, but I happen to have some of my own and I am paying for them myself.

Senator JOHNSON. I thought you said a moment ago you were sitting pretty.

Mr. SPENCE. I am. Look at the statements.

Senator CONNALLY. How much profit did you have last year?

Mr. SPENCE. I have forgotten exactly the sum. About $20,000, I think.

Senator CONNALLY. That is 10 percent.

Mr. SPENCE. Yes; we ran about 10 or 12 percent.

Senator GUFFEY. Do you get a good salary?

Mr. SPENCE. Yes; I get a good salary.

Senator CONNALLY. The salary comes out before taxes.

Mr. SPENCE. Well, you have to pay taxes, too, on salary.

Senator CONNALLY. I know that. I pay on mine, just the same as you do on yours. You say you made about 10 percent last year. You have an estimated net income for 1942 of $50,500.

Mr. SPENCE. That is right.

Senator CONNALLY. And about $32,000 of that is war profits.

Mr. SPENCE. Maybe it is.

Senator CONNALLY. Do you think you should pay something on that?

Mr. SPENCE. I am not trying to get out of paying on income. Don't get me wrong.

Senator CONNALLY. You were asking us to ask you some questions, and I am asking you.

Mr. SPENCE. I personally believe——

Senator CONNALLY. Don't get too close. I don't want any personal difficulties.

Mr. SPENCE. I personally believe, if you ask me, that every person should pay one-third of their increased income.

Taking the average income for the years 1936 to 1939, inclusive, I think everybody should pay, in 1942, one-third of their increase for the individual, but that is not a corporation.

Why? Because people do business on a corporation basis which is perfectly legal and well recognized, why should they be stuck? If my business was a partnership, my taxes would not be anything like as high as they are.

On the basis of net corporate income for the year 1942 of $50,500, one of our stockholders, a widow who owns 7½ percent of the stock and has outside income of $1,200, would, in reality, pay a tax of $2,505.68 on her proportionate share of $3,787.50 of the corporate income, on the assumption that all income earned by the corporation above taxes was to be distributed.

On the other hand, if the same income, the same amount of income were to be earned, either as wages, profits from an individual proprietorship, or a partnership, the total tax to be paid thereon would amount to but $773.25.

Therefore, this stockholder must pay additional taxes amounting to $1,732.43, simply because her income was derived from the earnings of a corporation.

This is not in pursuance of section 8 of the Constitution of the United States.

The CHAIRMAN. Is there anything else that you wish to say at this time?

Mr. SPENCE. Well, sir; I wish to reiterate what I did say, that the tax law should be designed to help us get out production, and it also should give us some credit for being smart and knowing how to turn over our capital fast.

The CHAIRMAN. You get that in profits, if you succeed in making them.

Mr. SPENCE. Well, sir, I do not see how you can get that in profits when this year my taxes, my corporation's taxes, on earnings of $50,000, will be $32,000. I do not see how you can call that making money.

Here are the figures.

Senator CONNALLY. Now you said you had $200,000 invested?

Mr. SPENCE. Yes.

Senator CONNALLY. You figure this year you will make $50,500.

The CHAIRMAN. You mean you will make $50,000 after taxes?

Mr. SPENCE. No, sir; we are figuring on $50,500 net profit before taxes.

Our taxes will be $32,000.

Senator CONNALLY. That is 25 percent, is it not, $50,000 on $200,000?

Mr. SPENCE. That is 25 percent, yes; but take the taxes out, then what do you have?

Senator CONNALLY. That is what I am talking about. That is why I am talking about the taxes.

If you make 25 percent net profit before taxes, some of it ought to go in taxes, ought it not?

Mr. SPENCE. Senator, don't get me wrong. I am not saying we should not pay taxes, but the taxes should be such that it leaves us enough to keep on doing business and encourages us to do more business.

Senator CONALLY. I think it will.

Mr. SPENCE. Not that tax, the way it stands now.

Senator CONNALLY. If your profit jumps from $20,000 last year to $50,500 this year it seems somebody helped you to do that.

Mr. SPENCE. Senator, let us put it the other way. Just supposing I had not had my plant in a position to get out that much business——

Senator CONNALLY. You would not have gotten it, of course.

Mr. SPENCE. Do you think Mr. du Pont, Mr. General Electric, and Mr. Albert Kahn, and all those fellows would have the reducing valves required to operate their war plants?

Senator CONNALLY. That is a technical matter.

Mr. SPENCE. It is very technical. That is the whole situation.

The CHAIRMAN. Your point is, the rate is too high?

Mr. SPENCE. Entirely too high for a small corporation, especially a corporation having a low capital and a big turn-over of their capital.

The CHAIRMAN. We appreciate your statement. Thank you, sir.

Mr. SPENCE. Thank you.

(Mr. Spence submitted the following memorandum:)

MEMORANDUM SUBMITTED BY PAULSEN SPENCE, REPRESENTING SPENCE ENGINEERING CO., INC., WALDEN, N. Y.

For instance, a manufacturer with whom I am personally acquainted who operates under the corporate form of organization, has an invested capital of approximately $350,000. This concern has been in business continuously for the past 100 years and manufactures an article essential for the manufacture of paper but not even remotely connected with war production.

The business has been extremely well managed and has been consistently profitable except during the depression years.

This concern, because of war restrictions, is unable to purchase raw material although it has on hand a sufficient supply to enable it to continue manufacturing the remainder of this year.

Due to war conditions, the business of its customers has fallen off to such an extent that it has received a great many cancelations of orders during the first 6 months of this year,, although it continued to manufacture, placing a good part of its finished products in stock so that it now has on hand a sufficient supply of finished goods to supply its customers during the remainder of this year.

A statement prepared as of June 30 showed a net profit for the 6 months of approximately $50,000 on which the tax calculated at present rates, will amount to approximately $25,700.

The problems with which this manufacturer is faced are the following:

1. It can close down its plant, throw all of its employees out of work, reduce its overhead to a minimum, and at the end of the year will have about the same amount of profit and taxes as at June 30.

2. It can continue operations at a fairly normal rate, placing the goods manufactured in stock, in which case the reduction in sales volume and underabsorption of overhead will by the end of the year in all likelihood not only eliminate the profit earned for the first 6 months of the year, but result in a considerable loss besides.

If the excess-profits tax were less burdensome to the small businessman, it is likely that this manufacturer would make a desperate effort to partially curtail his operations for the remaining 6 months of the year so as to enable him to make a reasonable profit. As the tax now stands however, he has about decided to discontinue operations and to absorb the profits earned during the first 6 months of the year through overhead expenditures with the result that the corporation will show no profit and therefore pay no taxes for the year 1942.

If such small manufacturers of essential commercial products who find it impossible because of the nature of their plant and equipment to convert to war production are to be not only deprived of their source of raw materials but also to be subjected to what amounts to confiscatory taxes, it will only take a few years to eliminate such producers from the field entirely with the resultant loss of their capital and the employment it would supply.

Returning to the Spence Engineering Co., Inc., situation:

In order to increase the volume of business from $313,000 for the year 1041 to approximately $464,000 for the year 1942, it will be necessary to expand the corporation's current position by increasing its working capital from current income by at least $15,000 which amount added to the liquidation of pressing current obligations of approximately $9,000, will result in the application of $24,000 of the income of the year 1942, leaving approximately $31,000 cash available for the payment of taxes aggregating $32,000 provided all accounts are collected and no unusual losses sustained, which would leave the corporation with no cash balance whatever at the end of the year.

Assuming that in accordance with the foregoing, all profits resulting from the increase in volume of business were converted into cash and used for the liquidation of taxes the corporation would then have current assets of $133,000, represented by accounts receivable of $48,800 and inventory of $84,200 against which it would have current liabilities represented by notes and accounts payable of $61,100 so that in order to liquidate its current liabilities, it would be obliged to collect 100 percent of its acounts receivable and in addition thereto, reduce its inventory some twenty-odd-thousand dollars, which would be impossible if the corporation is to continue in business.

SPENCE ENGINEERING CO., INC.

Pro forma calculation of income and excess-profits taxes for the year 1942, based on net income of $50,500

	Based on invested capital of—		
	$200,000 (1)	$341,700 (2)	$473,500 (3)
Excess-profits tax			
Normal tax net income	$50,500	$50,500.00	$50,500.00
Excess-profits net income	50,500	50,500.00	50,500.00
Less excess-profits credit, 8 percent	16,000	27,336.00	37,880.00
Balance	34,500	23,164.00	12,620.00
Less specific exemption	10,000	10,000.00	10,000.00
Adjusted excess-profits net income	24,500	13,164.00	2,620.00
Excess-profits tax, 90 percent	22,050	11,847.60	2,358.00
Normal tax			
Normal tax net income	50,500	50,500.00	50,500.00
Less adjusted excess-profits tax net income	24,500	13,164.00	2,620.00
Normal tax base	26,000	37,336.00	47,880.00
Normal tax	4,560	8,074.16	11,342.80
Surtax			
Normal and surtax base net income	26,000	37,336.00	47,880.00
Surtax	2,820	6,447.52	9,821.60
Total excess profits, normal, and surtax	29,430	26,309.28	23,522.40

(1) Based on invested capital represented by cost of assets acquired in reorganization by the issue of preferred stock.
(2) Based on sound value of assets—cost new less depreciation—as of the taxable year.
(3) Based on appraised value of assets—before depreciation as of the taxable year.

NOTE.—The New York State tax will approximate $3,000 additional for each year.

EXHIBIT A.—*Constructive balance sheet, Dec. 31, 1942*

Current assets:			
Cash on hand and on deposit		$31,365.94	
Accounts receivable	$36,769.98		
Less: Reserve for bad debts	3,663.89		
		33,106.09	
Inventories		84,217.52	
Cash surrender value of life insurance (net)		675.00	
Loan receivable—stockholder		175.83	
Total current assets			$149,540.38
Treasury stock			400.00
Capital assets:			
Land	$2,000.00		
Buildings, structures, and improvements	49,961.18		
Machinery and equipment	57,309.09		
Jigs, tools, and fixtures	13,552.59		
Patterns	41,137.67		
Flasks	1,875.00		
Automobiles	2,068.52		
Furniture and fixtures	5,554.21		
Drawings and cuts	12.53		
Total fixed assets		$173,470.79	
Less: Reserve for depreciation		42,429.70	
			131,041.09
Patents, unamortized cost			13,354.84
Deferred charges:			
Expenses paid in advance		$1,538.14	
Experimental expenses		608.17	
			2,146.31
Total			296,482.62
Current liabilities:			
Notes payable, banks		3,557.50	
Notes payable, others		14,500.00	
Accounts payable, trade		19,777.29	
Accounts payable, commissions		8,097.95	
Accrued accounts:			
Salaries and wages		5,637.83	
Taxes		9,499.95	
Miscellaneous		100.85	
Reserve for taxes		15,730.34	
Total current liabilities			76,901.71
Capital:			
Capital stock:			
Preferred 5 percent cumulative, no par value; authorized, 1,250 shares, issued and outstanding, 1,151 shares		$101,002.84	
Common stock, no par value; authorized, issued, and outstanding, 100 shares		5,000.00	
Total capital stock		106,002.84	
Surplus		113,578.07	
Total capital			219,580.91
Total			296,482.62

EXHIBIT B.—*Estimated summary of income for the year ending Dec. 31, 1942*

Net sales		$464,341.32
Cost of sales		275,638.50
Gross profit from sales		188,702.82
Taxes (social security, unemployment, franchise)	$1,286.90	
Selling, administrative, and financial expense	129,885.54	
		134,172.44
Net profit from operations		54,530.38
Other income		1,406.86
Net income for the period (before depreciation)		55,937.24

(The following letter and statement was submitted by Mr. Spence:)

SPENCE ENGINEERING CO., INC.,
WALDEN, N. Y., *August 4, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR: When I appeared before your honorable committee, Senator Connally questioned me regarding our earnings for the year 1941.

I did not have that information at my fingertips and the $20,000 I mentioned was that which was left after depreciation and Federal taxes.

I beg permission to add this letter and the attached profit and loss statement for the year 1941 to the record.

You will note that out of a profit of $36,070.20 we paid $10,660.35 Federal taxes, or approximately 30 percent.

We have the necessary machinery, the room, the engineering organization, drawings, tools, etc., required to turn out $928,682.64 worth of goods per year. This, based on our present operating conditions, would give us a net profit of $111,874.48.

If our total Federal tax were 30 percent (the same as 1941), we would not only double our production but would pay $33,562.34 in taxes which is more than we will pay this year.

This would leave us $78,312.14 which would be sufficient to finance the $928,682.64 business that we have the plant capacity to do.

For the information of your committee, I wish to state that I have already given orders that, unless the 1942 tax law is drastically modified, we are not to accept more than $30,000 worth of business per month, because that is all that I feel we can safely finance under the present tax program. If the Federal Government wishes to takes over our plant, it is welcome to do so.

It would seem to me, that at the present time when the all-important objective should be—win this war—and when we all know that the war cannot be won without greater production, it would be a tragic blunder to force small corporations, who have no means of securing necessary working capital except through earnings, by enacting an unconstitutional, confiscatory tax law, to reduce their production.

The situation would not be so bad if the law had a provision in it that, in case a taxpayer could not liquidate his inventory, the Federal Government would accept this inventory in lieu of taxes at its market value. In other words, in case business fell off to the point that we could not sell our inventory in order to pay taxes, we could load a truck with reducing valves and deliver them to the collector of internal revenue at Newburgh, N. Y. and say, "Here is your tax money."

I believe that the House of Representatives made a mistake when it placed all corporations in the same category. Large corporations have means of securing funds which are not open to small corporations.

Furthermore, the tax bill, in its present form, tends to accelerate the present trend toward concentrated economic control. Many thoughtful persons realize that it is this trend that is destroying our Constitutional Republic. If the Congress really believes in private enterprise, it should endeavor to halt this trend.

I, therefore, suggest:

1. That the combined normal corporation tax and surtax not exceed 30 percent.
2. That no excess-profits tax be levied on legitimate business corporations having a net worth up to $1,000,000, provided that no part of the excess profit is paid in dividends and that it be used for plant and business expansion or kept in reserve in the form of defense bonds.
3. That a graduated excess-profits tax be exacted on corporations having a net worth over $1,000,000 and up to $15,000,000.
4. That all corporations with a net worth of more than $15,000,000 pay the same excess-profits rate as were levied during 1941.

I wish to thank your honorable committee for the courteous attention accorded me.

Respectfully submitted.

SPENCE ENGINEERING CO., INC.,
PAULSEN SPENCE, *President.*

SPENCE ENGINEERING CO., INC.

SUMMARY OF INCOME (BEFORE DEPRECIATION AND FEDERAL TAXES) FOR THE YEAR ENDING DEC. 31, 1941

Net sales		$310,441.39
Cost of sales		174,566.91
Cross profit from sales		135,874.48
Taxes (social security, unemployment, franchise)	[1] $1,869.58	
Selling, administrative, and financial expense	98,866.73	
		100,736.31
Net profit from operations		35,138.17
Other income		932.03
Net income for the period		36,070.20
Taxes paid:		
Federal income tax		10,160.35
Capital stock tax		500.00

[1] Greater part of social security tax included in cost of sales—(shop).

The CHAIRMAN. I believe that exhausts the list of witnesses who were to appear, so the committee will recess until tomorrow morning at 10 o'clock.

(Whereupon, at the hour of 12:30 p. m., the committee recessed to 10 a. m., Friday, July 31, 1942.)

REVENUE ACT OF 1942

FRIDAY, JULY 31, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will come to order, please.

Mr. Bright.

Is Mr. Joseph E. Bright, of Buffalo, in the room?

(No response.)

The CHAIRMAN. Mr. Sturtevant.

STATEMENT OF RICHARD D. STURTEVANT, ASSISTANT SECRETARY, JEWEL TEA CO., INC., BARRINGTON, ILL.

The CHAIRMAN. Mr. Sturtevant, will you give your name and business connections and associations to the reporter?

Mr. STURTEVANT. My name is Richard D. Sturtevant, of Barrington, Ill.

I am assistant secretary of the Jewel Tea Co., and am also trustee or one of the trustees of the profits sharing and retirement program maintained by that company for its employees.

The CHAIRMAN. You are addressing your remarks, I believe, to the pension trusts?

Mr. STURTEVANT. The provisions of section 144 of the Revenue Act of 1942 as they deal with pensions and other employee benefit plans.

The CHAIRMAN. Yes, sir. All right, you may proceed with your statement.

Mr. STURTEVANT. In the interest of saving time, I will forego my inclination to spend some time with the details of the plan which we operate, but I wish to refer to the statement which I made before the House Ways and Means Committee in which those plans are described (see p. 2462, Hearings on Revenue Revision of 1942), and from time to time, as I cover certain points, will refer to our program and plans as illustrative of the points which I wish to make.

The CHAIRMAN. Yes, sir.

Mr. STURTEVANT. Then, if there are any questions about the details of the plan, of course, I will be glad to go into that, if there is time.

I plan to cover two things: First, to show why I believe that the provisions of section 144 as adopted by the House of Representatives, if enacted into law, will destroy incentive profit sharing, and second,

to tell you why I believe that it would be extremely detrimental to destroy those plans.

Senator VANDENBERG. You do not have to argue with me on either point.

Mr. STURTEVANT. That is encouraging, Senator Vandenberg. As a preliminary to the discussion of the first point, I think it might be well to point out that there are substantial and real differences between pension plans and profit-sharing plans, differences in objectives, differences in mechanics, differences which make it extremely difficult, if not impossible, to treat them in the same manner as has been attempted in this bill.

I think the result of the effort to treat them without distinction has been that here may be a fairly reasonable treatment, I believe, of pension plans, although there are undoubtedly objections from that standpoint, too, but from the standpoint of profit-sharing plans, the result is complete destruction of incentive profit sharing.

In speaking of profit sharing, I also ought to make it clear that I am speaking not of cash bonuses, which are, of course, not covered in this section, but speaking of plans which involve the use of retirement trusts, the placing of the money into a trust fund, as, of course, bonuses are not covered.

I think it might be well to also state that there are two types of profit-sharing plans of the deferred distribution type, one of which is broad in its coverage, and is primarily designed to provide a retirement fund for the greater percentage of the employees of an organization, somewhat comparable to the objectives of a pension plan but approaching it from the standpoint of making profits available for the building up of the fund; the second type is the one which I am more deeply concerned about and that I might designate as incentive profit sharing, the kind of profit sharing which depends for its effectiveness, upon the ability of the plan to incite the individual participants to greater effort and to greater efficiency, and to reward them for the accomplishment of the results which are over and above the normal standard of the work which is performed by those employees.

Senator BROWN. May I interrupt you there, sir?

Mr. STURTEVANT. Yes.

Senator BROWN. I think everybody agrees that the pension plan is a good thing.

Mr. STURTEVANT. I think so, too.

Senator BROWN. The Treasury's objection, I understand, and the thing that I would like to have you direct yourself to before you are through, is whether or not the pension plans may be used as a means of tax avoidance by people in the higher brackets.

Mr. STURTEVANT. I intend to deal with that.

Senator BROWN. That is the thing that concerns the Treasury and concerns the committee.

Mr. STURTEVANT. That, I am sure, is the major consideration, but I would like to give some of the background first, with your permission.

Turning then to the application of the provisions of this bill, or this measure, to profit-sharing plans, it is my belief that there are three major respects in which the bill makes it impossible for incentive profit sharing to continue.

The first is the requirement that 70 percent of the employees be covered. That is perfectly proper, I would say for the broad coverage type, but it is not designed to take care of the kind of profit sharing which I think is most effective in increasing the productiveness of this country.

It seems to me obvious that you cannot stimulate efficiency and increase productivity without granting individual rewards for the accomplishment of that objective, and you cannot do that on a broad basis for everybody. You can do it to some measure, of course, but what I am talking about now is the kind of profit sharing which fits the reward to the accomplishment, and the 70 percent just does not fit.

Senator VANDENBERG. I think you had better state precisely how your plan fits the reward to the accomplishment.

Mr. STURTEVANT. We have, Senator, two types of plans. We use both the broad coverage and incentive type in our organization. We have one trust which is adopted for all members of the organization, or for the benefit of all members of the organization, having 1 year or more of service, who voluntarily decide to join the plan.

That is what I call a broad coverage profit-sharing plan.

The CHAIRMAN. You have 70 percent of your people under that plan?

Mr. STURTEVANT. We have 70 percent of our people under that plan. The 70 percent coverage, I think, is proper for them.

But, we also have an incentive profit-sharing plan for those members of our organization, who are best able to influence the result of the organization, and that plan depends for its very success upon the ability to grant specific rewards for accomplishment.

Now, frankly, the 70 percent coverage provision probably will not hurt us individually because of the provision that the two trusts may be considered together for the purpose of coverage.

I do think, however, that as a matter of principle, it is not desirable to compel every company that wants to engage in profit sharing to go to the broad coverage type, because it does not always fit. There is much to be gained from the other kind of profit sharing.

Senator TAFT. What is the other kind?

Mr. STURTEVANT. The second kind of profit sharing, as I see it, is the kind of profit sharing which is applied to those people who are in the executive group, the mechanical genius who increases the effectiveness of the plant, the engineer, the chemist, those people who are in the key positions, and who are most able to influence profits. I believe it is extremely important to make it possible to continue to give an incentive to that group of people, whether or not it is possible also to do the other thing, which I say is very good, and which we believe in and do.

The CHAIRMAN. Well, I do not think anybody would disagree with you—anyone on this committee—that it is important to give encouragement to that particular group, but you do that in increased salaries, don't you?

Mr. STURTEVANT. Well, salaries are a means of reward.

The CHAIRMAN. I know. I want to make this suggestion right now: It seems to me the further you get away from a profit sharing or pension trust, which is truly a pension trust eligible to the masses of people in the industry, everybody in the industry, the more troubles you run

into, and the more some things, like some of the things in this bill that you do not like, would be creeping in.

Mr. STURTEVANT. Our experience is the most effective kind of profit sharing is the kind which stimulates individual activity over and above the normal activity of the people.

The CHAIRMAN. I agree with that.

You have got to consider that you are getting into certain types of benefits there. The further you travel away from the true concept of a pension trust the more difficulties you are bound to run into.

Mr. STURTEVANT. That is true, I believe, as applied to the pension objective. I do not think that is true as applied to the profit-sharing objective which, I might say, has been proven in our business, and I am sure it has been proven in hundreds of other businesses, that profit sharing is not merely a method of distributing profits which already exist but profit sharing is a method by which additional profits are created through the incentive which it creates, and thereby everyone gains.

Our experience along that line is rather striking, I believe, and I would like to refer, if I may, to the particular experience of our company on that point.

In 1924, our company first adopted a profit-sharing plan.

We have had experience continuously since that time. The first profit-sharing plan which we adopted was of the limited-coverage type. I think that is rather a standard. Most companies that even today have a broad-coverage type have evolved to that as we have.

The CHAIRMAN. I think you ought to evolve in that direction. I think you want to get away from the creation of special beneficial classes in the pension-trust system. I mean, I am using it in a broad general sense. I think, if you are properly advised, you should try to go in that general direction.

Mr. STURTEVANT. I think we have, Senator, but I believe there are so many values to the other kind that they ought not to be killed.

The CHAIRMAN. I know there are values to it, there is no question about that. You do not need to argue that point.

Mr. STURTEVANT. I would like to point out the results, taking and comparing the period from 1913, which was the date of incorporation of our company, through 1923, which I will designate as the pre-profit-sharing period against a period of 14 years following that period, during which we had an exclusively executive profit-sharing plan. The plan was set up first on the basis of rewards, after the company had earned a return which was considered a fair return to stockholders.

A base of $690,000 was set up, above which profits were to be shared. This base, by the way, was higher than had been the earned income for any one of the previous 5 years and compares to an average earnings for the period of 8 years of $74,000-odd.

The basis of the plan was individual reward for individual accomplishment during the profit-sharing period.

Senator CONNALLY. Was that for all of your employees, or just a few?

Mr. STURTEVANT. That was for a small group of employees, of people who, in the judgment——

Senator CONNALLY. The people who fixed the plan, who created the plan?

Mr. STURTEVANT. I must make it clear now, because you brought that up. That the plan was adopted by the board of directors, the majority of which do not participate in the plan.

It has been proven to the satisfaction of the board, which is responsible only to the stockholders, that the plan has been a good business proposition from the standpoint of the company, the stockholders and the Government, from the taxation standpoint of the Government of course. That is what I would like to point out.

The CHAIRMAN. Just tell us what you did, how you set it up.

Mr. STURTEVANT. We set it up, as I say, for the group which is, in the judgment of the board, the group which is most able to influence and increase productivity and profit.

Now, as a result of that, profits during the pre-profit-sharing period were $74,000 on the average. They increased in the following 14 years to an average of $1,320,000. In other words, the ratio of earnings to sales was about one-half of 1 percent in the first period as against 8¼ percent in the second.

Putting it in another way, out of each sales dollar during the pre-profit-sharing period this company was able to retain one-half cent as profit; during the second period of 14 years, under this particular plan, the company was able to retain 8¼ cents.

Now at the same time the Government was receiving an average of $74,000 in taxes during the pre-profit-sharing period as against $414,926 in the second period, and of course that only carries through 1938, and the taxes have greatly increased since that time under our more broad coverage plan.

It seems to me that that is particularly illustrative of the effectiveness of a plan of this kind and particularly so because we know that practically the entire difference between that very small profit in the early period as against the larger profit in the second period was due so much to the elimination of operating cost, something which was definitely within the control of the people who participated. It was not due to other factors. As I say, as the result of that, our board of directors, which cannot be charged with personal gain motives, is thoroughly satisfied that this plan has worked out to the benefit of stockholders—and I might say that nowadays, the Government is the biggest stockholder in every corporation that we have.

Profits which are earned are for the benefit of the Government as well as for the benefit of the stockholders, and plans which have proven their ability to accomplish that result, ought not to be killed.

Now, it seems to me that the report of the subcommittee of this Senate Finance Committee, as made a few years ago, is replete with illustrations of that kind, of profit-sharing plans which have produced profits way, far and above the cost. The result is that on the over-all effect, there is not any question at all in my mind, and I do not believe there would be a question in the minds of those who have thoroughly studied the report of the subcommittee that profit sharing on the whole has produced revenue for the Government, and has not resulted in any decrease in revenue.

Senator CONNALLY. Does the plan you now have include all the employees?

Mr. STURTEVANT. We have a broad plan which covers all employees with 1 or more years of service.

Now, a second feature of this bill, which is more destructive than the 70-percent-coverage provision, is the one which provides that the distributions of benefits which are provided under the trusts, or under all of the trusts, must not have the effect of discriminating in favor of any employee who receives compensation greater than any other employees.

Now, I do not know, frankly, just what is meant by "discrimination." I think there are tremendous problems involved in the interpretation of that section. It seems to me that it must mean one of two things: Either anything which produces a greater benefit is a discrimination, or we are going to have the situation where the courts are going to have to determine the merit of each individual participant, as to whether or not they have been treated fairly and reasonably within the plan. Either alternative, it seems to me, is impossible. The very heart of profit sharing is the right, or the ability to stimulate incentive and to reward it. You cannot reward it on a mass basis. Merely because the superintendent in the plant may develop a process by which the company saves substantial amounts of money does not mean that you should have to reward on the same basis every other employee of the whole organization.

Now that is all right if we are talking about general profit-sharing plans, if it is clear that there is an opportunity to grant rewards which have some ratio to accomplish, but that is not clear in this bill. I do not believe that we would be permitted under this bill, or our board of directors would not be permitted to continue even our broad profit-sharing plan under that section. There is not any question but that it would destroy incentive, that is profit sharing as such.

It is just an antithesis of the whole scheme of profit sharing.

Senator DANAHER. You would run into the prospect of officers voting themselves enormous salaries.

Mr. STURTEVANT. There are already adequate provisions against that sort of thing. The corporation is entitled to deduct from its expenses only the amounts which are adequate or reasonable compensation for services. Now, any amount put in a fund which, added to the amounts which have been received and are unreasonable, is clearly not deductible. In these days with excess-profits taxes and high corporate taxes, no corporation can possibly justify deducting any amount that cannot be sustained as reasonable compensation.

Senator DANAHER. How is the term "reasonable" to be defined and the term "discriminatory" against which you complain?

Mr. STURTEVANT. That is a test that has been applied to every kind of tax. It is the kind of thing which the courts have, over the years, created standards for. It seems to me it is adequate protection, but if it is not, if there is any question about that provision, it seems to me that it would be helpful to write into section 165, as applied to profit sharing, that express admonition, that the amounts put in trust when added to compensation otherwise secured or paid to those individuals cannot exceed the reasonable value of the services rendered.

Senator CONNALLY. Who is going to say what is reasonable? The Commissioner of Internal Revenue. When they do that you would kick like a bay steer, saying the Government interferes with profit business, going to socialism.

Mr. STURTEVANT. I would not object at all to that provision.

Senator CONNALLY. You would not, but all the rest of those in your fix will.

Mr. STURTEVANT. I do not believe so, Senator, because we know we have to sustain every business expense that we make as being a reasonable expense.

Senator CONNALLY. Just turn it over to the Commissioner of Internal Revenue to say what is reasonable or what is not reasonable; he might say too much or too little.

Mr. STURTEVANT. I believe the express writing into the bill of that provision would be a sufficient deterrent upon those who have abused that situation, in the way the Senators have suggested.

Senator CONNALLY. Of course, your original plan was nothing but a little bonus plan; it was not profit sharing at all.

Mr. STURTEVANT. It was based upon profits.

We have to earn a profit above a certain figure before we share, and then we share in a definite ascertainable percentage. That is profit sharing.

Senator CONNALLY. That is the original plan?

Mr. STURTEVANT. That is the original plan.

Senator CONNALLY. You have come out of it in recent years?

Mr. STURTEVANT. All of our plans have been based upon sharing a profit which is a definite percentage above a return which is a good, fair return.

Senator TAFT. How does the trust work? I understand, of course, the bonus, profit-sharing plan.

A man gets, we will say, $200. Where does the trust come in? Does the $200 go into a trust?

Where does he get it when he retires? Is it a pension plan?

Mr. STURTEVANT. It is a combination of profit-sharing and retirement benefits. It is not a real pension plan, inasmuch as a pension plan necessarily involves fixed obligations irrespective of profits.

It requires a certain actuarial computation in order to determine how much money would be produced for so many people on the basis of mortality tables, turn-over figures and so on, after a certain age, and consider how long people are expected to live, and so forth.

Now, in a profit-sharing plan, retirement funds are provided, but they are provided only if the corporation is able to earn profits.

Senator TAFT. But they are not paid to the man until he is 65 years of age, say.

Mr. STURTEVANT. That is the usual basis. In our particular fund, we have a graduated scale for payment. We feel 65 is pretty old to wait for everybody to get a retirement benefit, so we started out and say if a man stops working at any time, at the option of the company, after he is 50, he is retired with full benefits under the trust. If he quits of his own volition, then he gets full benefit at the age of 57.

There is a more-or-less mandatory retirement—automatic retirement at 65.

Senator DANAHER. One more question.

Mr. STURTEVANT. Yes.

Senator DANAHER. I do not see how you can ask that the words "found by the Commissioner not to be discriminatory" can have applied to them any other test than the test of reasonableness.

Mr. STURTEVANT. I have addressed myself to the following subdivision, primarily, rather than the one "found by the Commissioner."

That is an alternative to the 70-percent-coverage requirement, but the Commissioner is almost—in fact, I should say not almost but is absolutely required, in applying that test, to permit plans to qualify only if they are not for the benefit of shareholders, which is all right, and if it were for officers alone, that is all right, but it also mandatorily says that the Commissioner must exclude persons whose principal duties consist in supervising the work of their employees, and also must exclude people who are highly compensated.

Now, I submit that those who are highly compensated, those who are supervisory employees, are almost universally those who are most able to influence and produce profits, and that is established by many authorities. Textbook writers on the subject have said profit sharing is most effective when applied to that kind of group.

So, it excludes all but the very bottom group. I am not arguing against the bottom group, because I believe primarily that plans for them are to be encouraged, but I do not believe that because we want to encourage something which we all think is good, we ought to kill something else which is also good.

Senator TAFT. I suppose the term "discriminatory" would mean a man who makes twice as much should not get more than twice as big a percentage of profits?

Mr. STURTEVANT. That is one possible interpretation, Senator. I do not know whether that is sure enough so that we would be willing, for example, to agree if the company would be willing to deposit, as we did last year, over $200,000 in this trust for these broad employee groups, on the hope that that would be the interpretation adopted.

We cannot afford to make any payment which we are not going to be able to deduct, with rates what they are today. We have to earn tremendously increased amounts to pay any nondeductible expense.

I am afraid a board of directors which would make any payment of any kind which is not deductible in these days would be personally liable for a wastage of corporation funds.

Senator TAFT. You haven't anything against the 70-percent plan, have you? There is nothing discriminatory in it.

Mr. STURTEVANT. The benefits are measured in part, by salaries.

Senator TAFT. What other plan is there?

Mr. STURTEVANT. The amount which is deposited by the company is divided into two parts; one-half is distributed among the employees on the basis of the ratio of the individual's deposit in the fund to the deposit of the other employees.

It is a contributory fund. The employees may deposit from $1 to $4 a week. Actually, it is a combined contributory and profit-sharing program. We encourage and reward thrift with part of it, and then we divide the other part on the basis of salary.

That is all right. I think that is the only feasible, fair, and reasonable way to divide a general profit-sharing plan for all employees but I do not think that accomplishes the main objective of incentive profit sharing, which is to promote individual accomplishment.

We know that people respond to individual rewards. You are going to destroy that incentive because if the man down in the plant

who produces a valuable process is not going to get any more than someone else, it will destroy his incentive.

Senator GERRY. Would not you also get a reduction if it was a proper bonus?

Mr. STURTEVANT. If we paid cash bonuses?

Senator GERRY. If you gave a certain bonus on production?

Mr. STURTEVANT. Yes. I think, as a matter of fact, what will happen that plans which now provide for the payment of these moneys into trusts will probably be changed into the cash bonus system.

Senator GERRY. Suppose you paid the bonuses on the production, do not you get a reduction on them?

Mr. STURTEVANT. That might apply to a company which is engaged primarily in production. Now, our business is selling. We do pay our salesmen on a commission basis to stimulate that very thing; we also have other employees who are not on a commission basis. You cannot measure production definitely.

Now, it is impossible, it seems to me, to apply a production bonus to accomplishment of other types of workers, the office force, and so forth.

Senator GERRY. Why cannot you?

Mr. STURTEVANT. I do not know how to value my services on a production basis, and I am sure the board of directors does not. They know, in a general way.

Senator GERRY. How do you evaluate the services in the first proposition?

Mr. STURTEVANT. You have got to leave it to the discretion, as we do, of an impartial, nonparticipating committee of the board.

Senator GERRY. Why don't you do that in your bonus?

Mr. STURTEVANT. You have got to keep that group small enough so they can recognize and reward individual accomplishment.

Senator GERRY. You could reward individual accomplishment by a cash bonus, could you not?

Mr. STURTEVANT. You could. One of the other points I had in mind stressing, and I think that is exactly what the result of this would be, is that it is highly inflationary.

We know that the Government is greatly concerned about increasing purchasing power, and here we have a force which drains off purchasing power and holds it back, something we are striving for accomplishment, something which has the dual effect of instilling initiative and incentive and at the same time, draining off purchasing power.

Senator GUFFEY. How many officers are subject to the plan?

Mr. STURTEVANT. The senior plan, as we call it, the incentive plan covers approximately 80 persons in the organization.

Senator GERRY. How many stockholders have you?

Mr. STURTEVANT. About 6,000. We cover 44 States.

Another thing, as far as evaluating individual service is concerned, it is a little difficult to know exactly what everybody is doing all over the United States at every instant. We have a problem which you just cannot meet or reach with standard formulas.

Senator GUFFEY. There are other companies with the same plan?

Mr. STURTEVANT. There are millions of dollars in similar trusts. Definitely it is not our plan alone.

Senator TAFT. What do you invest your money in?

Mr. STURTEVANT. A very major portion goes into Government bonds.

Senator VANDENBERG. On the question of discrimination, Mr. Sturtevant, the report of the House Ways and Means Committee contains this sentence:

> Determination of benefits according to a fixed percentage of wages could not be considered discriminatory even though it results in larger benefits to highly paid employees.

Now that is the interpretation the House puts upon this language, yet it seems to me that it completely collides, precisely as you indicate, with the language of the bill which says benefits which do not have the effect of discriminating in favor of any employee whose compensation is greater than that of other employees.

In other words, the laws says everything must be equal, and the interpretation made by the House says that it does not have to be equal.

Mr. STURTEVANT. That is exactly the interpretation which might lead our board of directors to discontinue the plan rather than take the chance of making an undeductible expense for which they might be personally liable.

Senator CONNALLY. When you pay this money into this pension fund, this trust fund, does each individual get a vested interest in it, so when he quits or dies or leaves, he gets a certain percentage, or is it just sort of a fund to jockey with?

Mr. STURTEVANT. The amounts which are put in these trusts, both trusts are irrevocably paid, of course, to the beneficiaries of the trust.

Under no circumstances can they possibly revert to the company. They must be distributed to the employees.

Senator CONNALLY. I know, but does each individual have something that he can go to and say, "Now this is my money"?

Mr. STURTEVANT. I have to answer that in two ways, Senator.

Senator CONNALLY. Better answer it in one way.

Mr. STURTEVANT. I have to, because there are two different plans, and the result is different in the two plans.

The plan for the broad group of employees provides that if the employee leaves the service of the company during the first year following his joining the plan he gets his own deposit back, that is all, for the first year. After that there is a rather sharply graduated percentage of increase in the amount, or the percentage of the benefits in his account over and above his own deposit, which he would receive if he leaves. It goes sharply to 90 percent after 20 years and, of course, the full benefit after age 50.

The CHAIRMAN. Have you any other point that you wish to develop? You have taken considerable time and we have a long list of witnesses here.

Mr. STURTEVANT. Yes.

Senator TAFT. If he dies, do his descendants get anything?

Mr. STURTEVANT. That is one point I would like to make clear.

Each individual employee is entitled to designate a beneficiary, normally his wife or his children, who receive the benefit in the event he dies.

He gets the full benefits. It is my belief that the language of the bill as now drafted might prevent that, which I do not think was hardly intended, but the language of the bill, subsection (1) of section 165 as amended requires that the contributions be made to a trust under which the distributions are made to employees.

Now, it seems to me that that ought to be clarified to make it clear that the widows and children, and so on, of these people, can get benefits. I think that that was probably intended, but it is not clear.

I would like to make one other point and that is on this question of the deductibility of the amounts put in these trusts.

First, if the plan is a contributory plan and if it does not give nonforfeitable rights unless the plan qualifies under these standards, no part of the money deposited is deductible.

If, on the other hand, it gives nonforfeitable rights that amount is deductible, but the individual must take the amount deposited into income. Either one is impossible. It seems to me that my plan will have to qualify under section 165 or be discontinued.

Even if you qualify under section 165, the law has been drafted in such a way that all corporations are put on a cash basis on the payment to trusts. Now we put in 25 percent of our profit over and above $1.50 per common share. We cannot possibly determine what that figure will be during 1942. We cannot make any payment into the trust until about February of 1943. Thus, if this bill passes in its present form, it will be impossible for us to make any deduction for the amount deposited in 1942, which is a technical difficulty but a very real one, one which would have to be overcome in some way. We could not possibly justify making a payment which we cannot deduct against 1942 earnings.

I think that is a technical thing which can be corrected.

Furthermore, section 144 limits the amount to be deducted to 5 percent of compensation otherwise paid. It seems to me that is detrimental to the interest of the employees.

I think the 5 percent is bound to become a maximum, even though the balance may be distributed over the period of 5 years, because with the situation as it is today, I do not see how we could justify paying in any substantial sum which may be deducted 5 years from now, when we do not know whether we will have profits. The situation seems to me to be such that we cannot possibly pay more than 5 percent under this law. I do not see why we should limit the amount to be paid to these employees. You have to be able to deduct expenses in the year in which the expenses are incurred.

That is the fundamental principle of our tax law, which is being departed from here. I cannot see any reason for it.

I believe such abuses as may exist fall into two classes: First, and foremost, those situations where rather closely controlled corporations, with a majority of the stockholders on the board and a majority of stockholders who are the officers and participants in these plans, get together and vote themselves a bonus, because they do not want to take profits in dividends.

I think that is the most serious abuse, and we get 90 percent of the so-called abuses in that situation. That can be very easily corrected. You do not have to kill all incentive profit-sharing plans to correct that.

The second abuse is where a few top executives get all the amount and, as someone has suggested, the chances are good it might be an unreasonable amount. I think that can be cured by the limitation suggested.

You could write into the statute specific authority and direction to the revenue agents that they disallow any deduction which, when added to their compensation, is unreasonable, in view of the services of those men during that year.

Now, that seems to me to be the constructive program which should be followed by this committee, a program which will prevent at least 90 percent of any so-called abuses, and which will, at the same time, not interfere with the incentive value of these plans.

Now, I had occasion, within the past 2 days, to talk to a man who is in a very responsible position in the War Department. He told me that they are vitally concerned with doing everything they possibly can to cut down this wastage that is occurring in the production of materials for the Government, and here we have something which operates to do that, something which should be encouraged, fostered, not destroyed.

He expressed great concern with any program which would destroy the effectiveness of the profit-sharing motive in creating efficiency, cutting out waste. That is the biggest part. If you can induce a man to save a dollar so he can get 25 cents of it, it is going to be effective, but it is not going to be effective merely to say "If you save a dollar everybody in the whole organization is going to get half a cent added on their salary."

A broad coverage plan under which all share on the same ratio to salary just is not effective. It is valuable to some degree, but that is not the thing I am talking about, as far as the real incentive value of these plans is concerned.

I am taking a lot of time, I realize. I appreciate the opportunity of giving you my views. If there are any further questions, I will be glad to answer them.

The CHAIRMAN. We are very glad to hear from you. We have a great many witnesses this morning, and I presume they will cover generally the same question.

Mr. STURTEVANT. I am afraid most of them are concerned with pension plans. I would not have taken so much time except I believe I am the only profit-sharing witness here. I think the most important thing is to save profit-sharing plans which stimulate efficiency.

The CHAIRMAN. Have you in your brief the exact statement in regard to your own organization?

Mr. STURTEVANT. I do not have any written statement prepared.

The CHAIRMAN. Did you put it in the House proceedings?

Mr. STURTEVANT. I put it in the House proceedings in a written, prepared statement. It has the details of the plan very well set up.

The CHAIRMAN. That is in the House hearings?

Mr. STURTEVANT. That is in the House hearings; yes.

The CHAIRMAN. Thank you very much.

(The following statement was submitted by A. M. Christian, manager, Employees' Benefit Association, International Harvester Co.:)

STATEMENT SUBMITTED BY A. M. CHRISTIAN, MANAGER, INTERNATIONAL HARVESTER EMPLOYEES' BENEFIT ASSOCIATION

I. DESCRIPTION OF ASSOCIATION

The International Harvester Employees' Benefit Association (hereinafter called the E. B. A.) was established in 1908 as a voluntary unincorporated nonprofit association. It was organized to provide a fund for the payment of sickness, accident, and death benefits to employees of the Harvester Co. and affiliated companies. Membership in the E. B. A. is voluntary, but practically all the employees join. At the present time the E. B. A. has more than 60,000 members.

From the time the E. B. A. was organized in 1908 to the end of 1941 it had paid out to members $10,028,000 in death benefits and $10,422,000 in disability benefits.

The membership of the E. B. A. is composed of (1) those employees who join and (2) the Harvester Co. and its affiliated companies in this country and Canada. It is controlled by the board of trustees, half of whom are elected by the employee members, the other half being appointed by the company.

The funds of the E. B. A. are obtained from three sources: (1) Contributions by the employees, (2) contributions by the company, and (3) interest or dividends on the funds of the E. B. A. which are invested. Almost all the E. B. A.'s funds come from the first two sources, namely, the employees and the company; comparatively little is derived by way of investment income.

Prior to 1936 an employee member of the E. B. A. contributed 1½% of his weekly wages to the E. B. A. (but not to exceed 60 cents per week) and the company contributed a flat amount of $50,000 per year, which was designed to cover administrative costs. This arrangement continued until 1936.

In 1935 the trustees engaged a competent actuary to make a thorough study of the financial status of the E. B. A. As a result of that study, it was found that the E. B. A. had not been maintained on an actuarily sound basis. Two reasons were responsible for this condition: (1) The average age of the employee members had increased from about 30 years to nearly 38 years; and (2) there was greater stability in employment, with fewer people leaving the company. The result was that the E. B. A.'s reserves, which had been sufficient for a group averaging 30 years old with a large turn-over were not actuarily sufficient for a group almost 8 years older with a lower rate of turn-over.

To meet this situation it was decided to increase the contributions of the member, both the employees' and the company's. Accordingly, on May 22, 1936, the contributions for employee-members were raised from 1½ to 2¼ percent of the annual wages or salaries up to $2,080 annual income (i. e., a maximum of 90 cents per week). And the company, instead of furnishing a flat $50,000 per year, was to contribute an amount equal to 20 percent of the employees' contributions.

As a result, the company's payments increased to an average of approximately $420,000 for the years 1936 to 1941, exclusive. The increase, plus the higher payments made by the employees, was designed to restore the E. B. A. to a sound actuarial condition.

II. TAX STATUS OF ASSOCIATION

Prior to this change in the rate of contributions, the E. B. A. had considered itself exempt from taxation as a mutual benefit association under section 101 (16) of the applicable revenue act. That section provides that if 85 percent of the income of a mutual benefit association is received as contributions from members, the association is exempt from taxation. However, in 1940, the Bureau of Internal Revenue ruled that the contributions of the employer could not be considered as contributions of members and held that since on that construction less than 85 percent of the E. B. A.'s income consisted of amounts collected from members within the meaning of section 101 (16), the E. B. A. failed to qualify as an exempt mutual benefit association under that section. (G. C. M. 21323, 1940-1 C. B. 97.)

On the basis of that ruling the Bureau has proposed assessments against the association as an insurance company other than life or mutual, without giving it the benefit of any deduction of reserves. As a result of the Bureau's proposed

action, there is now a potential tax liability against the E. B. A. of about $1,600,000, plus interest for the 6 years 1935 to 1941, inclusive.[1]

III. POSITION OF THE E. B. A.

It is the position of the E. B. A. that the Bureau's construction of section 101 (16) is clearly unsound for the following reasons:

(1) The Bureau's construction conflicts with the obvious intent of Congress in enacting section 101 (16). The purpose of enacting the section was to encourage the formation of organizations which furnished low-cost insurance protection to employees by exempting their funds from taxation. A contribution by an employer clearly fosters such organizations, since it lowers the employee costs.

Moreover, when Congress, in 1928, enacted for the first time the provision corresponding to section 101 (16) it was well recognized that employers participated in and contributed to such organizations. As a matter of fact the enactment of the section was occasioned by the fact that several of such organizations, to which employers were contributing, had been subjected to tax because there was no specific provision exempting such organizations.[2] It is inconceivable, therefore, that Congress, in attempting to encourage such organizations by granting them tax-exempt status, should have intended to exclude those organizations which received substantial contributions from employers when it was a common practice for employers to make contributions to such organizations and when the organization could not have been operated economically without such employer contributions.

(2) The requirement in section 101 (16), that 85 percent of the income must be derived from members, was not enacted for the purpose of excluding employer contributions. The 85-percent requirement in section 101 (16) was taken over from a similar requirement in section 103 (10) of the 1928 act, relating to benevolent life insurance associations of a purely local character. When the latter section was adopted in the 1924 act, Congress indicated that it was adopting the 85-percent limitation in order to prevent otherwise exempt organizations from engaging in unrelated business activities. (See 65 Cong. Rec. 7128–7129.) Contributions by an employer can hardly be regarded as income from an unrelated business enterprise; and the Bureau has in effect recognized this in construing section 101 (10). (G. C. M. 5921, VIII-1 C. B. 179.) There is no basis for adopting a different position with respect to section 101 (16).

(3) Finally, the Bureau's construction of section 101 (16) is not only unwarranted under the statute, but also leads to an absurd result in the light of the cases and rulings under section 101 as a whole. For example, if the E. B. A. had received contributions solely from employees, there is no question but that it would be exempt under section 101 (16). Similarly, if the E. B. A. had received contributions solely from the employer-companies, it would be exempt under section 101 (6) of the applicable statute. (*Mutual Aid & Benefit Association of Forstmann & Huffmann Employees* v. *Commissioner*, 42 F. (2d) 619; and G. C. M. 19028, 1937-2 C. B. 125.) Moreover, if two separate organizations along the foregoing lines had been set up—one by the employees, receiving funds only from the employees; and the other by the employer, receiving funds only from the employer—and both organizations had cooperated in performing the identical functions for the benefit of the employees, both would be exempt. (*Gimbel* v. *Commissioner*, 54 F. (2d) 790.) But if these two otherwise exempt organizations are combined in a single organization to perform the identical functions and to receive the income from the identical sources—which is the situation with respect to the International Harvester Employees' Benefit Association—the organization loses its exemption under both section 101 (6) and 101 (16). The absurdity of such a result is obvious and indicates the fallacy of the Bureau's position.

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[1] In view of the startling amount of tax liability to which the E. B. A. might be subjected on this basis, the trustees in 1941 decided to transfer the death risks of the E. B. A. to a life insurance company. This has now been done. However, this action will not dispose of the large liability asserted by the Bureau against the E. B. A. for past years. Moreover, the question still remains, both for past and future years, for all employee benefit associations of a similar nature who have not reinsured or will not be able to reinsure their life risks with an independent life insurance company.

[2] See, e. g., *Philadelphia & Reading Relief Association*, 4 B. T. A. 713; *Employees' Benefit Association of American Steel Foundries*, 14 B. T. A. 1160; *Pontiac Employees Mutual Benefit Association*, 15 B. T. A. 74; *Mutual Aid & Benefit Association of Forstmann & Huffmann Employees*, 17 B. T. A. 997; *Atlantic Coast Line Railroad Co.* v. *U. S.*, 60 Ct. Cl. 378; A. R. R. 477, 4 C. B. 264; I. T. 2117, III-2 C. B. 220; I. T. 2291, V-1 C. B. 82.

IV. NECESSITY FOR RELIEF

The result of the Bureau's position would be to defeat the very purpose for which such associations are organized. If the Bureau's position is allowed to stand, a mutual benefit association would have to make up the loss from curtailed employer contributions by putting heavier assessments on the employee members. This would make the employees' costs too high. Many members would drop out of the mutual benefit association. That, in turn, would again increase the cost to those who remain. Thus, the purpose for which such associations were organized—namely, to furnish low-cost insurance protection to employees—would be defeated.

No legislation taking effect as of the present time would save the E. B. A., since approximately $1,600,000 in taxes, plus interest, has already been asserted against the E. B. A. for the years 1935 to 1941, inclusive. Accordingly, it is respectfully urged that an amendment to section 101 (16) be adopted by which an employer's contributions on behalf of employees would be classed with the employees' contributions in determining the right to tax exemption. This amendment should be retroactive in order to afford existing mutual benefit associations adequate protection against the depletion of their funds by reason of the assertion of tax liabilities contrary to the underlying purpose of the section.

Respectfully submitted.

EMPLOYEES' BENEFIT ASSOCIATION OF INTERNATIONAL HARVESTER CO. AND AFFILIATED COMPANIES.

The CHAIRMAN. Is Mr. Bright here?

STATEMENT OF JOSEPH E. BRIGHT, ESTATE ANALYST, BUFFALO, N. Y.

The CHAIRMAN. Mr. Bright, you were called before, but you were not here, so we will take you now.

Mr. BRIGHT. The Pennsylvania Railroad was responsible for that.

The CHAIRMAN. Come around. We will see what we can do with the Pennsylvania Railroad a little later on.

Mr. BRIGHT. That is a rather long subject.

The CHAIRMAN. All right, Mr. Bright, you may proceed.

Give the reporter your name and business connections.

Mr. BRIGHT. Joseph E. Bright; estate analyst, 122 Pearl Street, Buffalo, N. Y.

The CHAIRMAN. All right, sir.

Mr. BRIGHT. These are some suggestions to this committee, based on some experiences I have had in the study of the subject for a combination of pension and profit-sharing plans. Now it occurs to me, and it has occurred to me for some time, that pension plans are, of course, well known to you gentlemen, and many corporations who now have them and many more who are putting them on, and profit-sharing plans are likewise well-known and have been adopted and are being used by many corporations.

I am concerned with this thought, that pension plans—speaking now strictly of pension plans—are set up for fundamental purposes. The best figures I can get on the subject, show that about 17 or 18 out of every 20 wage-earners who reach 65 years of age are poverty-stricken. Pensions as I see it, are designed to prevent that situation.

I think we all can very readily agree that pensions are only possible through profits. I think we can likewise agree we are going to face years of no profits.

When we experience years of no profits, then these pension plans, which are economically sound, are faced with discontinuance.

If they are going to be faced with discontinuance, it occurs to me it is quite possible that those who are responsible for these plans might be charged with not having thought the matter through.

Therefore, may I suggest that a combination of a pension and profit-sharing plan be made possible.

The profit-sharing plan would serve two purposes: First, to enable the employees in years of production, in years when profits can be made, to participate in these profits; and, secondly, to assume the continuance of the pension plan over years of no profits, on the theory that if these plans are discontinued why, there is going to be an eruption, and probably rightly so.

That can be prevented by having a profit-sharing plan which enables funds to be withheld for three basic purposes; one purpose, and the primary purpose would be to use a portion of these profits withheld to pay pension premiums in years in which there are no profits.

The second portion of the profit-sharing plan is to be used to increase pensions. For example, let me assume that the pension plan provides a pension of 40 percent of the employee's salary (with a reasonable ceiling for pensions for higher-paid executives)—the profit-sharing plan to increase these pensions to, let me say, 50 percent of the employee's salary, maintaining a ceiling on higher paid executives.

The third phase of the plan would be current distribution to employees.

Now, I would like to suggest that in this profit-sharing plan a reasonable ceiling be put on the profit-sharing plan. It should be put on for two reasons:

(1) That excessive deductions could not be made by corporations. There are probably some that might try it.

(2) That labor should not take more than its fair share or be put in a position of demanding more than its fair share, because when anyone, regardless of whether he is labor, capital, or management, demands more than his fair share, why, you are headed for trouble.

I think that, in a few words, expresses what I have to say unless there are some questions.

The CHAIRMAN. Are there any questions, gentlemen?

Senator CLARK. Mr. Bright, to what extent do these private pension plans still exist after the passage of the Social Security Act? How many still continue?

Mr. BRIGHT. I haven't any figures before me, but I would say they have been multiplied hundreds of times.

Senator CLARK. You mean private pension plans?

Mr. BRIGHT. I am saying pension plans; I am not saying anything about profit-sharing plans.

Senator CLARK. As distinguished from the public pension plans contained in the Social Security Act.

Mr. BRIGHT. I do not think I got your question exactly.

Senator CLARK. I say, to what extent do these private pension plans of companies attempting to pension their own employees exist in addition to the pension provided by the Social Security Act?

To what extent do they exist since the Social Security Act was passed?

Mr. BRIGHT. My opinion is that they have been multiplied tremendously, that they have been increased one hundredfold, that is, in Buffalo. My territory is confined to Buffalo.

Senator CLARK. Beyond the Government pension plan as contained in the Social Security Act?

Mr. BRIGHT. Definitely so.

Senator RADCLIFFE. Do you think the Social Security Act has facilitated that?

Mr. BRIGHT. I think the Social Security Act has facilitated it. Having been in the life-insurance business, I remember when the Government put on a life insurance for the soldiers in the last war of $10,000. It was just after that that people began to realize what little income $10,000 would produce and life insurance made its greatest strides after the general buying of insurance by the soldiers.

Whether it was coincidental or not I do not know.

Senator RADCLIFFE. Do you think that policy will continue?

Mr. BRIGHT. I do not think there is any question about it. Judging by my limited territory, I know interest in these plans is greater today than it was 6 months ago, and much greater than it was 2 years ago.

The CHAIRMAN. If there are no further questions, we thank you, Mr. Bright, for your appearance.

Mr. BRIGHT. Yes, sir.

(Mr. Bright submitted the following memorandum:)

THE FUNDAMENTALS OF A PROPOSAL TO AUTHORIZE THE COMBINATION OF PENSION AND PROFIT-SHARING PLANS, SUBMITTED BY JOSEPH E. BRIGHT, BUFFALO, N. Y.

To enable corporations to attract and retain desirable officers and employees and to equitably reward these officers and employees—thereby insuring permanence of sound and efficient management—the combination of a pension and profit-sharing plan is herewith submitted.

It is believed that a soundly devised and equitably distributed plan, providing for both pensions and profit sharing, is essential to the economic welfare of the United States.

It is further believed that these plans will produce and continue to produce "new frontiers" of the sources of wealth.

This combination will assure to labor, to management, and to capital, each: Their fair and equitable share of the fruits of their joint efforts.

PENSION PHASE

A pension plan guarantees to an employee a reasonable income upon his retirement.—Without attempting to concern ourselves with the reason why, it is a well-known fact that at least 17 out of every 20 wage earners are penniless when they reach retirement age.

Each and every year some 800,000 to 1,000,000 wage earners reach retirement age. At least 85 percent of these are poverty-stricken.

This vast army of poverty-stricken citizens is supported from public treasuries or by relatives or friends.

Their support, received from public treasuries, is obviously a drain on the Nation's income.

Industry should see to it that these individuals' improvidence cannot result in their being thrown on society when they are no longer able to work.

Support received from relatives or friends definitely restricts the purchasing power of these relatives or friends to the essentials of life. i. e., food, shelter, and clothing.

The purchasing power of our citizens is considerably broadened when, through pensions, they are relieved from the necessity of providing for their dependent old-age relatives or friends.

PROFIT-SHARING PHASE

The profit-sharing phase of a pension plan is definitely essential.—The profit-sharing plan to provide, for example, that 10 percent of all corporate profits will be held in a separate fund.

This will guarantee to all qualified employees an equitable share of the wealth which their labors have produced.

It is suggested that distribution of these profits will be as follows:

A. Pensions are only possible from profits. It is impractical for any corporation to expect to realize profits in each and every year. To avoid any reasonable probability of a pension plan being discontinued, it is suggested that funds sufficient to pay 5 years' of pension premiums be accumulated and held as a "backlog."

B. Another portion of the profit-sharing plan to be withheld for employees until their retirement—with suitable provisions for a reasonable ceiling for higher paid employees. This withheld portion to supplement pension and social-security benefits.

C. Any remaining funds under the profit-sharing plan to be currently distributed.

A SOUND DEMOCRACY IS BEST MAINTAINED WHEN ITS CITIZENS ARE ENABLED TO ACQUIRE PROPERTY AND PROPERTY RIGHTS

A combination of pension and profit-sharing plans will—

Assure the continuation of the pension plan throughout years of no profits.

Equitably reward labor, management, and capital in prosperous years.

SUGGESTIONS

It is suggested that a ceiling be placed on the percentage of profits allowable to a profit-sharing plan.

This ceiling would prevent—

(*a*) Excessive deductions by corporations.

(*b*) Demands from labor for more than its fair share.

It is likewise suggested that the profit-sharing plan must apply to any and all profits and not be limited to profits in excess of a certain amount.

It is further suggested that these plans be available to only those corporations pensioning all of their employees—granting reasonable exemptions for casual and part-time employees and for those employed less than a reasonable minimum period.

STATEMENT OF EUGENE M. KLEIN, OF EUGENE M. KLEIN ASSOCIATES, CLEVELAND, OHIO

The CHAIRMAN. Mr. Klein, you may give your name to the reporter.

Mr. KLEIN. Eugene M. Klein, of Eugene M. Klein Associates, pension consultants, 917 NBC Building, Cleveland, Ohio.

The CHAIRMAN. You may proceed, Mr. Klein.

Mr. KLEIN. May I say to the committee, first, that the old sections 165 and 23 (p) in the revenue act fairly well met the pension requirements as we saw them, but that there were a few points in there which allowed tax evasion, and that those were properly covered by the House bill as it exists today.

We believe that Mr. Randolph Paul covered the point very thoroughly.

Senator TAFT. Mr. Klein, what is your business?

Mr. KLEIN. Pension consultant.

Senator TAFT. In Cleveland, Ohio?

Mr. KLEIN. In Cleveland, Ohio; yes. We work all over the country, however.

Senator TAFT. How many clients do you have?

Mr. KLEIN. We have about 350 plans in operation now, which we are servicing from year to year. We have been 14 years now doing nothing but pension work.

There is only one thing that we object to in the House bill and that we believe will tend to destroy a great number of the plans now in operation and will also prevent the introduction of new pension plans.

I believe the committee is firmly convinced that pension plans are a necessity today to augment and supplement the Social Security Act. The Social Security Act takes care of the lower-price employees, those earning, say, under $1,500; it takes care of them adequately. It does not take care of those earnings more than that in an adequate manner.

Most of these plans that have been established have been honest plans installed with the idea of supplementing social security, so the men earning $3,000, $2,400, $4,800, or $5,000 would also benefit by a proper pension, so they might retire.

The fact is that under the Social Security Act only 280,000 men have been retired, and there are over 1,200,000 men, according to the 1940 census, who are beyond 65 and still in industry. That is taking out farm labor and taking out emergency Government work. There are altogether 4,500,000 men today of the age 55 or more, who will be a big problem, as we see it, to industry, and who will be ready for retirement as soon as the war effort ceases.

Now, the only objection that we have to the House bill is the section which proposes a deduction to the employer not to exceed 5 percent of the aggregate salaries of the men included in the plan. A survey of all our plans has shown that that 5 percent is entirely inadequate.

We have a chart here of a very worth-while concern, one who is known throughout the country for their relations with their employees. They have been written up probably more than any other cooncern, and that particular exhibit shows that the average cost to the employer for this plan, after the employee contribution has been made, is 11.8 percent.

That must be considered better than the average plan. We have taken other plans into consideration.

Senator VANDENBERG. What company is that?

Mr. KLEIN. That is the Doehler Die-Casting Co.

We have taken other plans. Some of these are 35 or 40 percent of salary as pension, with social security included. In other words, any employee in this group can get over 35 in some cases and 40 percent in others of their salary as pensions.

We believe a 40-percent pension is a proper pension, large enough for a man to live on as a decent American and small enough for the company to afford it.

We find these percentages shown. In the case of a Cleveland manufacturing company, 23.2 percent; in the case of a Buffalo chemical company, 16.6 percent.

In the case of a Buffalo rubber company, 23.2 percent.

In the case of a Toledo machine tool company, 18.6 percent.

In the case of a department store in Buffalo, 24 percent.

A blueprint-paper manufacturer and machine manufacturer in New York, 14.6 percent.

A spark-plug company in Toledo, 14.7 percent.

Senator TAFT. They start out with a pension that will retire the employees at 35 or 40 percent, or some percentage of their salary?

Mr. KLEIN. Yes.

Senator TAFT. And they figure perhaps they cannot take over 5 percent from the employees themselves?

Mr. KLEIN. That is right.

Senator TAFT. In order to reach that goal they have to put up these percentages; is that right?

Mr. KLEIN. Yes.

Senator TAFT. Would that be true of a sound actuarial plan starting right from the beginning, or is it because of the fact that they usually begin with men of all ages?

Mr. KLEIN. That is the reason for it. Those concerns putting in 24 percent and 18 percent are concerns where there are very old people, where the people are almost ready for retirement.

In order to inaugurate the plan, the payment, in the first few years of the plan, is higher than after that, in order to retire those men who are near retirement age or who are ready for immediate retirement.

Senator TAFT. In the normal course the percentages would come down?

Mr. KLEIN. That is right. It is my belief that a 10-percent ceiling, after the plan has been in operation for 10 years will be more than sufficient.

Now, here is a chart, exhibit B, which shows just what may be provided, and what pensions are provided. Under this 5-percent rule we would get it up where we would find as low as 7.9 percent is all the pension, including the social security, that may be provided for men 65 years of age, none of which reach the 40-percent limit.

There was nothing in Mr. Paul's report to the House Ways and Means Committee which asked for this 5 percent, and we believe that the 5 percent is not necessary to curb the abuses which we had under the old law. We believe the 70-percent provision will curb a great number of them. We believe the nondiscriminatory rule will curb others, and that altogether the law, as it stands today, will curb the abuses which were had under the old act. However, we believe that limiting the payments to 5 percent will destroy all these plans that are now in operation, and will prevent the induction of new plans.

Now, as an example of what this 5 percent does with these companies that I mentioned before, the first company deposits a total of $59,500. Under the 5 percent of pay roll they would be allowed to deduct $13,358.50 only. Under the excess provision over 5 percent they would be allowed to deduct an additional $9,228, or a total of $22,586.

Then the taxable amount in that year would be $36,913.20. Now that would be practically impossible to pay, if not deductible, because it would take, if they were in the 90-percent class, or way up in the excess-profits tax, it would take approximately the earnings of 10 times that $39,000, or $369,000 approximately, to pay that balance of tax.

Now that would be impossible with this concern, and with all the others that we know of.

Senator VANDENBERG. Why, the net result, I suppose, would be to cut the pension plan back.

Mr. KLEIN. To either stop it entirely or to limit the company's contribution to 5 percent, which would produce a pension which would not be satisfactory, and which would not retire the men, because no man could retire on 20 or 22 percent of his salary.

That is the reason 280,000 retired out of 1,500,000.

Here is a company that deposits $140,000, and the amount which they would have to pay taxes on, the amount which they would have to earn to pay taxes on would be $739,000, because of that 5-percent limitation.

Now, we have made four suggestions to the committee here which we think will carry out the plan. In the first place, if that 5 percent were changed to 15 percent and the company were not allowed to deposit over 15 percent of the aggregate salaries of those included in the plan, we think that would cover it.

A second solution set forth here is we allow him to take a full deduction of the amount which he put in the plan, making it actuarially correct, the way the old law did, and over and above the current pension liability that is allowed him to take his deduction for the current company's liability for that year, and all over that over the period of 5 years.

The third is to allow a deduction of, say, 5 percent up to age 40, then grade it, 10 percent, say, to 50; 15 percent to age 55, and so forth, so these men would be adequately taken care of and the company could continue its plan.

Senator DANAHER. Mr. Klein, is that actuarially computable, or is that arbitrary?

Mr. KLEIN. No; it was actuarially computable; it was under the old law entirely, under the law as it existed up to date.

Senator DANAHER. Thank you.

Mr. KLEIN. The fourth generation is the suggestion that Mr. Paul made, that is that you allow full deductibility for the current expenses and putting a ceiling on what any man may get. We believe Mr. Paul's suggestion of $7,500 might be a little bit low. Possibly it should be $10,000 or $12,000 as a ceiling.

I think Mr. Paul just said $7,500 as putting on some sort of ceiling.

I think that would cure all the defects of the present plan, to limit the actuarial deductions for current expenditures during the year, the current liability, and just a ceiling on it.

But the 5 percent definitely, without question, will destroy almost any and every plan that we have, because the companies will not be able to continue to pay great sums of money say about $40,000 or $50,000 of their net profits after all taxes have been paid.

I do know further that no new plan will be inaugurated, unless it is a haphazard plan, and such plan will not do the work that a pension plan should do, that is, provide income for the man upon retirement from which he can live as a decent American.

Senator BROWN. I think the illustration you give at the bottom of page 7 and top of page 8 is what the Doehler plant would have to earn in order to pay the amount of premium above the $37,000 should be given to the committee. That is a very vivid illustration.

Mr. KLEIN. Yes; we have that in the charts here, and the same on several other companies' systems.

Senator BROWN. In other words, in order to pay the $37,629, if Doehler is in the 90 percent excessive-profits classification, they would have to earn $376,000?

Mr. KLEIN. That is right. May I leave those charts?

The CHAIRMAN. Yes; you may leave those charts.

Are there any further questions from Mr. Klein?
Thank you very much, Mr. Klein.
(Mr. Klein submitted the following memorandum and charts.)

MEMORANDUM BY EUGENE M. KLEIN, CLEVELAND, OHIO

My purpose in appearing before this committee is to express my opinion regarding section 144 of the proposed revenue bill for 1942, which section relates to employees' trusts.

At the outset I want to state that the intent of Congress to weed out the narrow, discriminating, selfish type of pension and bonus plan which has cast suspicion over bona fide plans is an admirable objective, which we believe will be fully accomplished by the proposed section 165 (a). We believe also that with the exception of the proposed section 23 (p) (1) (A) and (C) (i) the rest of the section 144 is equitable. It is clear, and there should be no misunderstandings concerning the application of it.

My comment here is directed solely to that portion of the amended section which allows a tax deduction to the employer of amounts paid into a tax-exempt trust during the taxable year of not more than 5 percent of the compensation paid to his employees during that year, and also allows a deduction over a 5-year period for any amounts paid into such trust which are in excess of the 5 percent amounts so paid.

We believe that the injection of such a limited incentive for pension plans will seriously retard the establishment of new bona fide pension and annuity plans and hinder the maintenance of plans already established. There are many reasons why we believe that this section should be changed.

(1) *The sound social object of pension plans demands full Government cooperation.*—In the comprehensive Senate subcommittee report No. 610, which was a survey of experiences in profit sharing and the possibilities of incentive taxation, the following was stated on page 93:

"Nothing in all world history has equaled the production of wealth, and creation of the standard of living enjoyed by our people, the inventive genius, the material progress and prosperity of America. But there is one great vulnerable spot in our capitalistic economy. That is the fact that annually in America several million people * * * finish their lifetime of work in penury and want. The system will be the object of continuous, ever-increasing attack so long as this situation exists. In fact, the system cannot long endure with such a condition being the annual output of its operation."

"Therefore," the committee stated that, "object No. 1 of our recommended plan should be:

"1 Provision for the creation of an estate or retirement fund for the protection of old age."

It is evident that the objective of all bona fide retirement plans is directly related to the welfare of our economy. These are not merely words. Latest available census data indicate that in 1940, 2 years ago, with the exception of persons employed in public emergency work or on the farm, there were approximately 1,200,000 employees over age 65; 1,300,000 employees were between the ages of 60 to 64, inclusive; 2,000,000 employees were between the ages of 55 and 59, inclusive, making a total of slightly over 4,500,000 persons employed who were 55 years of age or more.

These employees constitute an enormous potential old-age problem. It is highly probable that this group of older employees has been considerably enlarged since the beginning of the war due to the urgent need for manpower in defense industries.

Enabling this older group of employees to retire within the next decade will not only relieve this serious problem, but it will enable millions of young employees who otherwise would be unemployed to find work.

The fact that only about 280,000 employees have already retired under the benefits of the Social Security Act, and that there are still over 1,000,000 persons employed who are 65 years of age or more indicates the unwillingness of employees to retire under the bare minimum of retirement security provided under the social security system. Retirement plans are needed to fill the gap in the social security program.

The distribution of the ages of our population has been constantly changing. People are living longer, and we are finding, and we are going to continue to

find, an increasing number of persons growing old who are facing problems of economic security. It is highly significant that the total number of persons over age 65 in 1940 was 30 percent higher than that which prevailed under the 1930 census. It should appear important that any company which is interested in providing economic security for this older group of employees should be given the fullest cooperation.

The preservation and maintenance of our present economy will be largely dependent upon the Government's attitude with respect to company-sponsored retirement plans. Any inducement by Congress which effectively tends to make the employer solve the problems of poverty in old age is fundamentally sound. In effect it relieves the Government of a weighty problem which it would otherwise have to bear. It is a serious problem as the statistics indicate.

While it is with us at a time when we are fighting for our system of living, it is directly tied in with our war effort; it is vitally important that the viewpoint of employees in defense industries should not be distorted by thoughts of insecurity; and a retirement plan goes a long way in relieving the anxiety, the fear, and the worry that accompanies old age. It is becoming increasingly difficult for employees to provide for their own economic security. Higher individual taxes, lower exemptions, and a higher standard of living have all contributed to the employee's inability to meet his individual security problems.

To meet this increasing problem of old age and to some extent future unemployment, the initiative must be taken now, and the incentive must be allowed now toward that objective. Retirement-plan financing is a long-term project, and waiting, delaying and procrastinating will simply and finally evoke a tragic economic situation accompanied by the unavailing, depressing expression—"too late."

On the basis of sound social reasons, therefore, Congress should fully cooperate with employers who are operating bona fide retirement plans.

(2) The proposed deduction to the employer in a taxable year of an amount not in excess of 5 percent of an employee's compensation during that year is unnecessary and detrimental because—

(*a*) It extends much beyond the point needed to curb undesirable pension practices, and

(*b*) It will tend to deprive employees of adequate security and thereby jeopardize the over-all social objective of retirement plans.

Before elaborating upon these two points, it is well to review the prevailing practices relating to the financing of retirement plans.

Up to the present there have been two principal methods of financing pension plans.

First, an employer could purchase annuities directly from an insurance company. Ordinarily he gave pension credits to his employees for future and past service. The cost of future service pensions he paid off from year to year. The cost of past service pensions were paid off either in a lump sum or over a very few years. The Internal Revenue Department rules that such payment were fully deductible for tax purposes in the current year in which the payment actually was made.

As a second method of setting up a pension plan, an employer could set up a trust in accordance with section 165. By virtue of section 23 (a) the employer was allowed to deduct in the taxable year his contributions which covered his pension liability which accrued during that year. If the employer deposited an amount in excess of his pension liability which accrued during that year, for the purpose of financing past service credits, then, by virtue of section 23 (p) the employer had to apportion his tax deduction over a period of 10 years.

Most employers who could afford depositing large sums of money during 1 year deposited hundreds of thousands and even millions of dollars directly with an insurance company during a single year to cover past service liabilities and secured a full tax deduction in the year of deposit. Some companies carried these practices to unorthodox ends. For example, if an employer established a trust which met the requirements of section 165, he would deposit only that amount of money into the trust which necessary to cover his current pension liabilities, and in order to avoid apportioning his past service liability over a period of 10 consecutive years, would pay the cost of such past services directly to an insurance company, and thereby secure a full tax deduction in the year of deposit of whatever payments he made.

The sole objection which has prevailed against retirement plan financing has revolved around this widespread single deposit practice for past service. The

objection has never extended to future service deposits under group annuity plans, or to current pension deposits under pension trust plans. These latter deposits have never been considered as undesirable practices. The charging to expenses in 1 year of the amount of pension liability which accrued only during that year was a normal and expected procedure. Since deposits for current pension liabilities have an actuarial basis, the amounts deposited to cover that liability are definite and not subject to arbitrary manipulation by the employer as is possible with past service deposits.

The undesirable practice of making enormous deposits in 1 year and taking a full deduction in that 1 year is adequately curbed under the proposed section which requires such payments to be spread over a 5-year period. However, since the allowance to the employer in a taxable year of an amount not in excess of 5 percent of the emp'oyee's compensation is not nearly sufficient to meet the cost of current liabilities under most pension plans, the 5-percent limitation extends much beyond what was intended to be curbed.

As an example of this point that the 5 percent limitation does not meet current liabilities, let us take a practical case as an illustration. The Doehler Die Casting Co.—a company which has been given widespread publicity for its generous dealings with its employees—maintains a retirement plan for all salaried employees earning $1,560 or more a year, who are 40 years of age or over. Here we have a chart (exhibit A) which shows approximately what it costs that company to operate its plan. The costs are shown for each age and are expressed as a percentage of the total compensation of each employee at such age up to a maximum of $12,000 a year to any employee (the maximum salary upon which pensions are based). Pensions are approximately 40 percent of salary including social security. The retirement age for employees who enter the plan up to age 55 is 65, and for employees who enter the plan beyond that age, retirement ages are staggered.

It is evident from a study of this chart that the percentage of an employee's salary which the employer must deposit to meet a single year's pension liability to provide an adequate pension, including social security, is above the 5 percent-of-salary line for all employees participating, and is well above it where the retirement problem is greatest. The 5 percent-of-salary allowance clearly does not meet the current pension liability requirements of this company. This case is not unusual—it is typical.

I repeat—the 5 percent limitation extends much beyond what was intended to be curbed.

This leads us to the second point that a 5 percent limitation will tend to deprive employees of adequate security and thereby jeopardize the over-all social objective of retirement plans.

There never were many companies which were able to deposit enormous sums of money in a single year. Most of the companies which did so represented the very large industrial organizations. Those companies which could not afford to make huge deposits in a single year allocated their costs over a period of years, depositing amounts sufficient to meet current liabilities, and in many cases only made payments when they were able to do so. Since there are so many employers who are only able to maintain pension plans because they obtain a full tax deduction in the year of deposit for current liabilities, and since the 5-percent limitation does not cover current liabilities, it will be virtually impossible for the ordinary employer to risk making payments in excess of 5 percent of an employee's compensation, and take deductions over a period of years in which there may be no net income.

Let us refer back to the Doehler case to illustrate this point. Doehler current pension liability is $81,838.08 a year. Their pay roll for the eligible employees amounts to $690,022 a year, 5 percent of which is $34,801.10. They are entitled to deduct from expenses this $34,801.10 plus $9,407.40, which represents 2 percent of the excess over 5 percent, or a total of $44,208.50. This leaves $37,629.58 of current liability cost which the company must take a deduction for over the next 4 years. In order to be able to pay this $37,629.58, if Doehler is in the 90-percent-excess-profits classification, they must have a gross earning which amounts to at least $376,295.80.

This type of condition will spell the death warrant for many existing retirement plans, and will prevent the establishment of new plans. The average company will be unable to make deposits in excess of the 5 percent, and will be compelled to discontinue their plan or adopt or operate a limited type of pension plan—possibly to the extent of 5 percent of an employee's compen-

sation. The maintenance of limited pension plans will deprive many employees of much-needed economic security.

This next exhibit (exhibit B) illustrates what percentage of salary could be provided for an employee beginning at age 65 by a 5-percent-of-salary deposit by the employer, a graduated scale of employees' deposits, and Social Security. It is apparent that employees who enter the plan at lower ages are satisfactorily taken care of by such contributions. But it is also apparent that the older the employee and the higher his salary at the time he enters the plan, the less security provided for him. A person earning $1,500 a year who enters the plan at age 60 would secure a pension of $120 a year. This is clearly inadequate. As salaries increase, these percentages and amounts progressively decrease. They are inadequate and would not permit an employee to live decently in the American way after retirement.

We are interested today primarily in the retirement problem which will develop during the course of the next decade. We are interested in these older employees whose economic security will be jeopardized by the limitations of the proposed section. For a retirement plan to be effective at all, it must provide proper security; a failure to provide this adequacy defeats the object of the entire plan, and thereby prevents the solution of a vital social problem.

I might add here that my remarks are directed solely to pension and annuity plans and are not intended to apply to stock bonus or profit-sharing plans. I believe that these latter two plans should be treated on a different basis.

(3) It is unfortunate that the proposed tax deduction to the employer will have the effect of penalizing those socially minded companies which were unable to deposit hundreds of thousands and even millions of dollars into pension plans in 1 year to pay for past service, and had to spread the cost of their pension plan over the remaining years of an employee's working lifetime. Large companies which deposited millions of dollars for past service credits will be in a favorable position because their future service deposits will be relatively low. However, the smaller companies are penalized, because, being unable to deposit millions of dollars in the 1 year, they distributed their costs over the employee's working lifetime, with the result that their annual costs are higher than they would have been had they been financially able to make deposits in a single year.

In conclusion we ask the committee to consider the following methods of changing the proposed section 23 (p) (A) and (C) (1):

The following methods apply to an employer who contributes to a trust which is exempt from taxes under the proposed section 165 (a), or under a plan of deferred payment which would be exempt from taxes under section 165 (a) if it constituted a trust instead of a plan for the purchase of annuity contracts.

(1) Allow the employer a full tax deduction on his contributions which cover his pension liability accruing during the year, and allow him to take a tax deduction on amounts in excess of such current pension liability over a period of 5 consecutive years, or

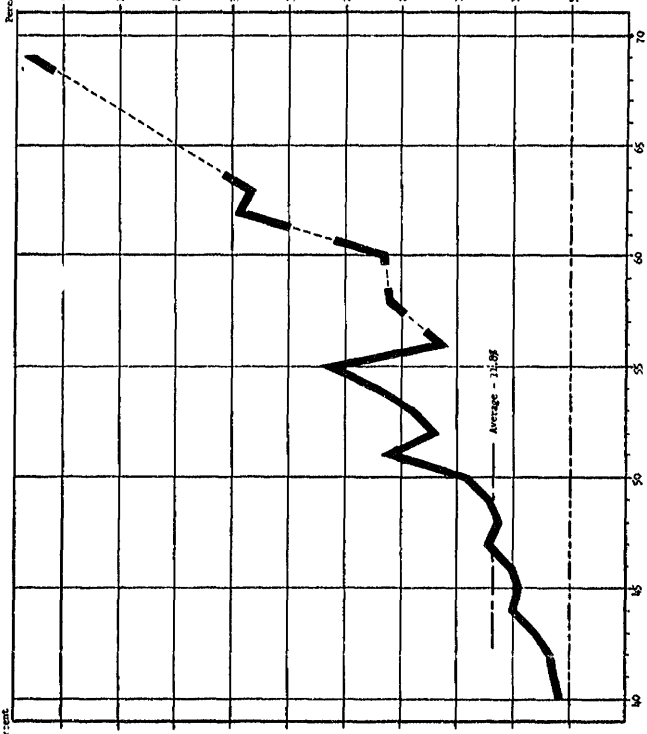
(2) Allow the employer a full tax deduction in the year of taxation of amounts not in excess of 15 percent of the aggregate compensation paid to participating employees during the taxable year, and allow him to take a tax deduction on amounts in excess of such 15 percent over a period of 5 consecutive years, or

(3) Allow the employer a full tax deduction in the taxable year of amounts not in excess of 5 percent of the aggregate compensation of employees who enter the plan under age 40, or not in excess of a certain percentage graduated according to the age of the employee at the time of his entry to the plan, if he is then age 40 or over. The excess over such percentages should be deductible over a period of 5 consecutive years, or

(4) Allow the employer a full tax deduction on his contributions which cover his pension liability accruing during the year, and allow him to take a tax deduction on amounts in excess of such current pension liability over a period of 5 consecutive years, but if the pension benefits of an employee exceed let us say $7,500 or $10,000 a year, such employee should include in income currently his pro-rata share of his employer's contribution to the trust and the earnings of the trust. (Mr. Randolph Paul's original suggestion.)

We believe that any one of these methods will go a long way toward assuring a continuance of proper employee security under present and future retirement plans.

EXHIBIT A.—TYPICAL EMPLOYER'S COST EXPRESSED AS A PERCENTAGE OF AGGREGATE EMPLOYEE COMPENSATION AT EACH AGE



SPECIFICATIONS OF PLAN

(1) Based on the use of individual level premium annuity contracts.

(2) Provides a pension of approximately 40 percent of employee's salary including social security.

(3) Employees contribute 2 percent of first $3,000, and 5 percent of excess over $3,000.

(4) Employer pays balance of cost, and at least equals employee's deposit.

(5) Employees retire as follows:

Age at entry to—	*Retirement Age*
55	65
56	66
57	67
58	68
59	69
60–64	70
65 and over	75

EXHIBIT B

Amount of annual pension provided, including social security beginning at age 65, by an annual payment by employer of 5 percent of an employee's annual salary and a graduated scale of employee contributions, expressed as a percentage of annual salary.

[The scale of annual employee contributions is graduated according to age at entry as follows: to age 34, 2 percent; 35–44, 3 percent; 45–54, 4 percent; 55 and over, 5 percent]

Annual salary	Age at entry							
	25	30	35	40	45	50	55	60
$1,500	75.7	66.0	61.4	52.9	47.7	40.0	34.4	28.6
$2,400	69.1	59.7	55.2	47.0	42.0	34.6	29.2	23.6
$3,000	66.9	57.5	53.2	45.0	40.1	32.8	27.5	21.9
$5,000	57.6	48.5	44.5	36.7	32.0	25.0	20.0	14.8
$10,000	50.6	41.8	38.0	30.4	26.0	19.2	14.5	7.9

EXHIBIT C

Analysis of tax status of certain retirement plans under proposed Revenue Act of 1942

Company	Pension provided	Annual pay roll of participants	Annual cost to employer		Composition of amounts fully deductible in year of deposit			Taxable amount in year of deposit	Gross amount company would have to earn, if in the 90-percent excess-profits-tax class, to deposit amount specified in column 9
			Amount	Expressed as percentage of pay roll	5 percent of pay roll	20 percent of excess over 5 percent	Total		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
				Percent					
Dill Manufacturing Co	40 percent with social security	$267,170	$59,500	22.3	$13,358.50	$9,228.30	$22,586.80	$36,913.20	$369,132.00
Buffalo Electro Chemical	30 percent, no social security	208,140	34,500	16.6	10,407.00	4,818.60	15,225.60	19,274.40	192,744.00
Hewitt Rubber Corporation	do	210,820	49,000	23.2	10,541.00	7,691.80	18,232.80	30,767.20	307,672.00
Baker Brothers	40 percent with social security	107,636	20,000	18.6	5,381.80	2,923.64	8,305.44	11,694.56	116,945.60
Startler's, Inc	40 percent, no social security	187,300	45,000	24.0	9,365.00	7,127.00	16,492.00	28,508.00	285,080.00
Chas. Bruning, Inc	30 percent, no social security	99,600	14,500	14.6	4,980.00	1,904.00	6,884.00	7,616.00	76,160.00
Champion Spark Plug Co	35 percent with social security	952,280	140,030	14.7	47,614.00	18,477.20	66,091.20	73,908.80	739,088.00
Doehler Die Casting Co		696,000	81,840	11.8	34,800.00	9,403.00	44,203.00	37,552.00	376,320.00

The CHAIRMAN. Mr. Beers.

STATEMENT OF HENRY S. BEERS, HARTFORD, CONN., REPRESENTING THE ASSOCIATION OF LIFE INSURANCE PRESIDENTS

The CHAIRMAN. Mr. Beers, will you give the reporter your name and your business connections?

Mr. BEERS. Henry S. Beers. I represent the Association of Life Insurance Presidents, which consists of most of the life insurance companies in the country, and I am the chairman of a special committee particularly on behalf of those members of the Life Insurance President's Association which do a group annuity business to provide pension plans for employers.

I am also chairman of the Group Association, which includes most of the companies doing a group annuity business. My business connection is the Aetna Life Insurance Co., of which I am vice president in charge of the group department.

I am speaking particularly and only from the point of view of group annuity contracts which provide pension plans for employers.

As far as general principles go, we are in favor of the bill if read in connection with pages 51 and 104 of the House Ways and Means Committee report on the bill, if we understand the meaning of that report. However, we feel it of vital importance that greater assurance be given in the text of the law that pension plans which we think the Commissioner of Internal Revenue intends to approve were intended by Congress to be approved under section 165 (a).

Pension plans, of course, cost a lot of money, and you should endeavor to make it possible for an employer, with an approvable plan, to read the text of the law and see that it is approvable. If he can do that, it will save the Bureau of Internal Revenue a lot of inquiries about specific plans. It will avoid litigation, and it will avoid the unnecessary discontinuance or suspension of perfectly sound plans by companies which do not dare take a chance on the ultimate deductibility of their pension contributions.

Of course, we realize that it is impossible to set up in a bill exhaustive standards by which you can judge every possible pension plan that may come along, because there are so many different types of pension plans. We suggest, however, that you indicate in the text of the law a very few general standards, thinking that this should serve, by comparison, to validate immediately and clearly the great majority of acceptable plans, leaving only a minority of border-line plans for special study by the Bureau of Internal Revenue. Now, we have a specific suggestion to this effect but, unfortunately, it is now only half drafted and I should like permission to write you, giving you our specific suggestions in writing. But this suggestion will probably run to the effect that "a stock bonus, pension, or profit-sharing plan shall not be considered discriminatory within the meaning of the requirements of section 165 (a) merely because the benefits to employees are substantially in proportion to their rates of compensation." That is stated in the House report, but it is not stated in the bill itself. Nor merely because it is designed to exclude employees none of whose remuneration is excluded from "wages" by section 1426 (a) (1), the Social Security Act old-age tax provision.

That is to say, plans may exclude employees earning less than $3,000 per year who are covered by the Social Security Act. They can, as stated by the House Ways and Means Committee report, be acceptable, but we feel it should be stated in the law itself.

"Nor merely because the benefits to employees based on that part of the employees' remuneration which is excluded by those taxing provisions differ from the benefits based on remuneration not so excluded." That is to say, a plan which provides a lower percentage of salary on the first $3,000 than the percentage of salary allowed on the excess over $3,000 should be validated in the law.

I think it was the intention of the drafters of the bill to allow such a plan, because if you get a certain social-security pension on your first $3 000, it is quite proper and reasonable that your pension from the private plan should be, for example, 1 percent of the first $3,000 of your salary times years of service, and on the excess over $3,000, 2 percent of salary times years of service.

Thus the low-paid employees would be paid 1 percent plus social security, and the high-paid employees would get on the first $3,000, 1 percent of their salary times years of service, and on the balance 2 percent of their salary times years of service.

Senator CLARK. On that matter, for instance, I saw in the paper the other day where Mr. Grace, of Bethlehem Steel Co., drew salaries of $600 000 last year or a little less than $600,000. Do you think he ought to be included in such a plan?

Mr. BEERS. I do not want to take a gratuitous slam against the remuneration of Mr. Grace.

Senator CLARK. I thought of that as an example, because I saw it in the paper last week.

Mr. BEERS. I personally do not go along with the inclusion of a salary of that kind for pension purposes.

Senator CLARK. I have nothing against Mr. Grace personally, simply because I happened to see it in the paper.

Mr. BEERS. If there should be some kind of limit in this bill, I do not think I should take an exception to it, sir.

I want to say there are a great many plans which have been adopted in the last few years which give a higher percentage on salary over $3,000 than on the salary under $3,000, and those plans seem reasonable to me and I think they were intended to be included in this legislation. If they were intended to be included, it should be so stated, because I am afraid otherwise it would be impossible for any employer to feel that he could prove they were included, in which case he would be scared to death to pay out any money for fear that it would not be deductible. As pointed out by the last speaker, it is pretty hard to find money to pay nondeductible expenses in these days, and pension plans, particularly group annuity plans, are very expensive to employers.

Senator VANDENBERG. You are sustained by the sentence which I read a moment ago from the House Ways and Means Committee report, which I will read:

> Determination of benefits according to a fixed percentage of wages should not be considered discriminatory even though it results in larger benefits to highly paid employees.

Mr. BEERS. Even that sentence, sir, does not seem to me to go far enough to cover the plan I am talking about.

Senator TAFT. You mean, if the pension plan plus what they get from social security is in proportion to the salary, then that shall not be considered discriminatory?

Mr. BEERS. Yes, sir. I think the law should provide the test which you have just stated, and that it ought to be provided in the law and not merely in a committee report or reports, because my legal friends tell me you cannot read the committee report unless the law is vague, or something like that.

The CHAIRMAN. You will have these suggestions written out?

Mr. BEERS. We will ask permission to write you, and if you wish, you can put them in your record, or do whatever is proper.

The CHAIRMAN. We will be very glad to put them in the record. We will be very glad to have them by the time we reach the executive session stage.

Mr. BEERE. I will get them to you, I hope, in the next few days.

The CHAIRMAN. You will have time.

Mr. BEERS. The next point I want to bring up is about the two sections of this bill about discrimination: Section 165 (a) contains two different kinds of discrimination. One is discrimination in favor of officers, shareholders, supervisory employees, highly compensated employees. That is section 165 (a) (3) (B), and the next subsection is (4), which subsection says that the discrimination shall not be in favor of any employee whose compensation is greater than that of other employees.

We have not been able to find any very good reason for these two different kinds of discrimination. We suggest it may lead to a great deal of difficulty and hairsplitting, and so forth. We suggest you use the same kind of discrimination in both subsections; namely, that you declare against discrimination in favor of officers, shareholders, employees whose principal duties are the supervising of other employees, and highly compensated employees.

I have not intended to change the language of section 165 (a) (3) (B). I am quoting from memory.

Senator DANAHER. That is substantially correct.

Mr. BEERS. Thank you, Senator.

Now, my third point is this: Section 165 (a) (3) says that the plan must be offered to 70 percent of all employees of over 5 years' service, or to a certain class of employees approved by the Commissioner.

A good many plans are contributory, and there is always a minority of employees who will not accept the benefit of a plan for any contribution whatsoever, so they stay out, and we suggest and ask that you change the language there to read that the plan must be offered to at least 70 percent of the employees, and so forth, instead of that the plan must benefit 70 percent of the employees.

I do not think it was the intention of the drafters to require that 70 percent be covered, but only that 70 percent be offered coverage, and if that was the intention, I think it should be made clear in the bill.

Senator VANDENBERG. Or 70 percent of eligible employees.

Mr. BEERS. Yes, sir. "Eligible" is a good word.

Now my fourth point—and I am getting to the end of these notes—is that section 165 (a) (2), which says that the trust fund must not be

diverted to purposes other than the exclusive benefit of the employees, the wording of that section does not seem to fit the requirements of a good many group annuity contracts which we believe your committee would feel to be acceptable.

It is a rather technical point, and we ask permission to file our specific suggestions in writing with respect to this and also with respect to a few other minor points.

It now looks as if, from a drafting standpoint, we may make the suggestion that the rules applying to group annuity contracts be stated separately, but if we do, that would merely be for drafting reasons and to assist rather than to confuse your drafters in their work of making such changes as your committee decides upon.

Senator VANDENBERG. Could that language be construed to exclude death benefits to the family of an employee?

Mr. BEERS. I have not thought of that, sir. In general, group annuity contracts provide only that employees' contributions to the plan will be returned, usually with interest, sometimes without, to the employee's beneficiary. There is usually no benefit from the employer's contribution to the employee's family. I haven't got any point along that line, and I think probably from a group annuity standpoint the bill is all right in that respect.

Senator RADCLIFFE. You suggest that the benefits must be offered to at least 70 percent?

Mr. BEERS. Yes.

Senator RADCLIFFE. Would you fix any minimum limit as to what percentage you should expect to set up?

Mr. BEERS. It would not be objectionable to us, I think, except for this reason: There might be a time when a plan covering the minimum limit you state fell below that minimum limit. There might be a new campaign, as we call it, and the percentage of employees might be improved, but then we could not say that that plan met the test throughout the whole of the taxable year, and we would be in trouble again.

Senator RADCLIFFE. What about if only 20 percent subscribed to the plan?

Mr. BEERS. If only 20 percent, or 5 percent, or something, subscribed to the plan, I suspect, sir, you would find that the scheme of contributions was discriminatory in favor of a limited class, so the plan would be thrown out anyway.

Senator RADCLIFFE. You would not suggest an arbitrary minimum?

Mr. BEERS. I should not suggest an arbitrary minimum; I should say once you had what is a reasonable minimum it does not seem unreasonable.

Senator DANAHER. Please do not depart from section 165 (a) (2) for a moment. You said your possible suggestion with reference to it is highly technical and you would like later to submit a further memorandum with reference to it, but in order that we may test your suggestion when you submit it, will you now elaborate on your comment as to why you imply a criticism of the language of section 165 (a) (2)?

Mr. BEERS. Yes, sir. Group annuity contracts generally provide, as far as I know always provide, that if an employee, under certain circumstances, leaves the employment before he has completed certain vesting requirements, if the employee is in good health at that time, the employer is entitled to have the money he paid for that employee's

benefits reapplied it to purchase benefits for other employees. Or to state it in more ordinary language, he gets a refund which he has to apply against his current premiums. However, it is conceivable in any case that the refunds due at that time might exceed any premiums payable then or in the near future.

That happened to us in one case where a lot of employees withdrew all at once. The employer did wait a long while before he got all that refund, and in the meantime he did not pay any premiums. Under our contracts, therefore, in such a case the employer has the option of drawing out in cash usually 95 percent of the amount he could have received as a credit. Under the present law if he did that he would, of course, have to show what he drew out as being income at that time. But such a plan would not meet the strict test that no part of the corpus or interest could be applied other than for the benefit of the employee.

Senator TAFT. It seems to me it would be distinctly prohibited by this section.

Mr. BEERS. You are right, sir.

Senator TAFT. It is not a technical question; it seems to me to be a question of principle whether once an employer has paid this in, he should be able to get it back in any way or not. The Treasury says not, I take it. They say under such plan you have to change your plan. Hereafter that money would have to be added, I take it, to the corpus of the fund for the benefit of other employees, and they would have to go ahead and pay a premium besides, I should think.

Mr. BEERS. If the return is used to pay part of the employer's premium in the year in which the return comes due, or in some subsequent year, I do not think that you could say that that money was not being used for the exclusive benefit of the employees, although some of us feel that the law ought to make that clear.

Senator TAFT. Take the ordinary fund in which the insurance company is involved, the fund gradually accumulates a reserve perhaps because of the fact that employees have withdrawn, or because of other facts, and that reserve I suppose has to stay there under this rule for the benefit of the other employees who are in the fund.

Mr. BEERS. That is right.

Senator TAFT. On the other hand, I suppose the employer might reduce his payments thereafter and still comply with the provisions of the fund.

Mr. BEERS. That is right.

Senator TAFT. It seems to me subsection (2) requires a clarification as to just what we are trying to do. If that is permitted, I think it ought to be clearly stated.

Mr. BEERS. I think it is arguable whether, under any circumstances whatever, a net return could be made to an employer. I am not sure that the intention of the present bill is not a correct one. On the other hand, group annuity contracts differ from a good many pension trust funds in that under a group annuity contract the employer buys the full benefit for each person employed, without discounting his payments by reason of the probability that a number of his present employees will leave service between now and retirement. Well, in a great many pension trust funds he discounts his payment by reason of probable future withdrawals. Therefore, you would be, in a sense, discriminating against group annuity contracts, if you apply the same

rule to both. I am not sure you will not decide to do that—I think, in any event, some clarification of language is going to be needed.

Senator TAFT. We have had called to our attention here a fund in which the employee makes no contribution.

Mr. BEERS. Yes, sir.

Senator TAFT. The employer has paid, for years, 1 percent. It has been the custom when the employee leaves the service, if he does leave it voluntarily to withdraw the money that he put in there for that employee, where he put it all in himself.

Mr. BEERS. Yes, sir.

Senator TAFT. I suppose that would be prohibited by this section (2), also.

Mr. BEERS. Does not that depend on whether the withdrawal is less than this year's net payment?

Senator TAFT. If that is the case, subsection (2) ought to say it.

Mr. BEERS. I think it ought to say so; that is, if the employer uses a credit to pay part of this year's premium he is certainly using the credit for the benefit of the employees. On the other hand, somebody else might take the other attitude.

Senator DANAHER. Mr. Chairman, may I ask the witness a question that is collateral to this subject?

The CHAIRMAN. Yes, Senator.

Senator DANAHER. Are you, by any chance, familiar with the system of the Bell Telephone Co. with reference to its employees?

Mr. BEERS. I am very sorry; I have only a very general familiarity which does not go into details, sir.

The CHAIRMAN. All right.

Mr. BEERS. The next point I want to make is that on page 113, the first five lines, it is stated that an employee is taxed on past employer contributions if his benefits change from a forfeitable to a nonforfeitable status. I believe that this should be restricted to employer contributions made in a taxable year beginning after December 31, 1941, or otherwise you would tax the employee in the future on payments made by the employer a long time ago, when the tax situation was different. I do not think that is a proper retroactive feature, and I think you will find my suggestion will remove it, but that again is a matter of detail.

I have one more specific point, namely, that many group annuity contracts are going to require minor changes to conform to the new requirements. This will present a drafting problem. We have to get the contract amendments approved by the employers' lawyers and our lawyers, and sometimes the insurance department, and even stockholders' approval will have to be obtained. Under the present bill I think all this will have to be done before December 31. We should like to ask that at least 1 year after the date of enactment be given to make those changes because of all the things that have to be done and the steps to be gone through. I do not think it will change the net tax collections at all if you do that.

My comments go into matters of detail rather than matters of broad, general principle. My excuse for asking permission to address you this morning is that it seems to me very clear that the present bill, section 165 (a), looks to be a lot more restrictive than it was intended to be, that it is possible to change that situation, and that if it is not corrected a lot of harm may be done to many thousands

of employees through the discontinuance of the pension plans by which they are now covered, which, in realty, are perfectly sound from every point of view, but which the employer will not dare take a chance on on account of the very high tax rate that he would have to pay if his contributions were not deductible.

Senator DANAHER. Mr. Chairman, I would like to ask Mr. Beers to look at two paragraphs of a letter that I have here, which bear specifically on the problem before us, and I will ask him if he would read them for the information of the committee, so that we might have the benefit of his actuarial views with reference to that. Could we spare him another 2 minutes on that account?

The CHAIRMAN. Yes, sir.

Mr. BEERS. Senator Danaher used the word "actuarial." I am a fellow of the Actuarial Society of America. The paragraphs read:

> I have read in a summary of the Treasury Department's recent tax proposals that tax exemption will not be accorded to pension trust unless the rights of employees thereunder are fully vested. The Southern New England Telephone Co., with its 5,200 employees, has had a pension plan with a trust fund based on actuarial principles for more than 15 years. Under the terms of this plan, pensions are determined by the application of a common formula to officers and employees alike. Employees make no payments, but the trust fund, built up by annual contributions of the company, is irrevocably dedicated to service pensions.
>
> If the Treasury's proposal becomes law, one of the actuarial bases of the pension plan will be destroyed for the fund will be depleted every time an employee leaves the company. Our studies indicate that the cost of any attempt to make up this depletion or the expense if the pension trust fund does not continue tax exempt, would, in either case, be so prohibitive that the company would have no alternative but to terminate the entire pension plan.

This is a letter from the Southern New England Telephone Co., dated March 19, 1942, to the Honorable John A. Danaher, from Mr. E. L. Simonds, vice president.

Senator DANAHER. That is correct. Would you choose to comment on his criticism of this language? It ties in with what I think you are criticizing at the top of page 113.

Senator TAFT. Why would the fund be depleted when an employee retires?

Mr. BEERS. Under the Bell system pension plan, the pension benefits are contingent on an employee staying with the company until he achieves pension status. That is, I think he has to reach age 65 after 20 years of service, or age 60 after 25 years of service, or age 50 after 30 years of service, or something of that sort. If he leaves before that time, say at the age of 40, after 15 years of service, he is entitled to no benefits. The original proposal being studied by the House at the time that letter was written was that such an employee must be allowed to take away with him a pension credit, so when he reached age 65 he would be entitled to that money under the Bell system.

The CHAIRMAN. That was not included in the bill?

Mr. BEERS. That was not included in the bill.

The CHAIRMAN. It was evidently based upon the original recommendation of the Treasury.

Mr. BEERS. Yes; that is right, sir.

(Senator Danaher referred to p. 113 of the bill, H. R. 7378, as passed by the House.)

Senator DANAHER. The first five lines.

Mr. BEERS. The present bill says that if a plan does not meet the test of section 165 (a) and does not vest immediately, the employer gets no

deduction, but when the benefits do vest the employee has to pay a tax, the employer still gets no deduction. The vesting idea is that the employer's contributions may change from a forfeitable to a nonforfeitable status. The original proposal discussed by that letter is not, I think, in this bill at all.

Senator DANAHER. All right. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Beers.

Mr. BEERS. Thank you.

The CHAIRMAN. Mr. Forster.

(The following letter was submitted by Mr. Beers:)

AETNA LIFE INSURANCE CO.,
Hartford, Conn., August 5, 1942.

THE SENATE COMMITTEE ON FINANCE,
United States Senate, Washington, D. C.

Re Section 144 of the Revenue Bill of 1942, H. R. 7378.

GENTLEMEN: At the hearing held before your committee on July 31 in regard to section 141 of the revenue bill of 1942, relating to employees' trusts and annuity plans, I appeared on behalf of a special committee of the Association of Life Insurance Presidents which had been appointed to consider this section of the new bill. You kindly granted us permission to file later in writing our suggestions as to changes which it might be desirable to make in section 144 of the bill. This letter is written pursuant to that permission.

This committee, as stated at the hearing, only undertakes to speak for life insurance companies which provide pension plans for employers and employees through group annuity contracts and in the particular interest of those employers who have heretofore purchased such contracts and are making retirement provision for their employees thereunder. Such contracts now have been issued to more than 1,000 employers, large and small, covering some 800,000 employees.

We have no objection to the objectives represented by the House bill. We are, however, solicitous that no undue hardship be worked by new legislation upon employers who have heretofore in good faith and in the light of then existing tax legislation made provision by means of group annuity plans for the retirement of their employees, nor upon the employees covered by such plans. This committee, as suggested at the hearing, believes that to avoid the possibility of any such hardship, clarification of the House bill in several respects, as outlined herein, is desirable.

The following changes should, in the opinion of our committee, be made in section 144.

(1) Section 165 (a) (3) now states that one of the requirements to qualify a plan under that section is that the plan shall "benefit" either (*a*) 70 percent or more of all employees with certain stated exceptions or (*b*) such employees as qualify under certain tests. Group annuity contracts are usually written on a contributory basis, under which the cost is paid in part by the employer and in part by the employees for whose benefit the contract is made. Some employees may not choose to make or to continue to make the contributions which are required in order to avail themselves of the benefits of the plan. We believe that a plan which makes the benefits available to 70 percent or more of all the employees of an employer, subject to the exclusions mentioned in section 165 (a) (3) (A), and which meets the requirements of section 165 (a) (4) should be considered a qualified plan, even though the percentage of employees actually subscribing may fall somewhat below 70 percent. We therefore suggest that the word "benefit" in line 15 on page 111 of the House bill be changed to "offer benefits to".

However, if the Senate committee concludes that the test should be based on the percentage of employees who actually subscribe to the plan, rather than on the percentage of employees to whom its benefits are made available, then we suggest that "70 per centum" be changed to "50 per centum." We believe that a plan which actually covers at least 50 percent of permanent employees with more than 5 years' service and which meets the test of section 165 (a) (4) should be considered a qualified plan without its having to be specially passed upon by the Commissioner. As between these two suggestions, however, we would prefer the first.

(2) Section 165 (a) (3) (B) requires that a plan qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. This provision relates to the classification of employees to whom benefits are offered. Section 165 (a) (4) relates to the contributions and benefits under the plan and requires that such contributions or benefits do not have the effect of discriminating in favor of any employee whose compensation is greater than that of other employees. We do not know why one test for discrimination is set up in section 165 (a) (3) (B) and another test in section 165 (a) (4). We believe that this will unnecessarily complicate the administration of the act. We further believe that the test set up in section 165 (a) (4) would be apt to prevent plans from being considered qualified which should be considered qualified. As an example, an employer may have a pension plan under the terms of which all employees who are on a salary basis will be provided with pensions strictly in proportion to salary, but employees who are working on an hourly basis or who are paid by commission may be provided with a pension based entirely on the number of years of service or on some other basis different from that used in determining the pensions of salaried employees. It should not be hard to determine whether such a plan is discriminatory in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees, but it might be very difficult to determine whether the plan, as between the salaried employees and other classes of employees, discriminates in favor of any employee whose compensation is greater than that of other employees. We therefore suggest that the same test be made applicable to contributions and benefits as is applicable to eligibility, which can be done by eliminating the words "have the effect of discriminating in favor of any employee whose compensation is greater than that of other employees" in lines 11 to 13 on page 112 of the House bill and inserting in place thereof the words "discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

(3) The House committee report on the bill indicates that it is not the intention of the bill to outlaw pension plans which make the pensions proportionate to the compensation of the employees covered under the plan nor which supplement the benefits payable under the Social Security Act or the Carriers Taxing Act of 1937. While this intention seems clear from the report of the House committee, we do not feel that it is made clear in the bill itself. It is our understanding that committee reports and comment on the floor of the legislative body during debate are not necessarily binding in the construction of an act after it is passed, even though they may be admissible to show the intent of the legislative body where the bill is ambiguous. We feel that it would be much more desirable to have the intent of Congress on these points expressed in the bill itself. We therefore suggest the insertion at the end of section 165 (a), which would be between lines 13 and 14 on page 112 of the House bill, of a sentence reading as follows:

"A pension plan shall not be considered discriminatory within the meaning of either of the foregoing requirements merely because the benefits for the employees or for qualified classes of employees bear a uniform relationship to their rates of compensation; nor merely because it is designed to exclude employees none of whose remuneration is excluded from 'wages' by section 1426 (a) (1); nor merely because the benefits (or benefits and corresponding contributions) based on that part of an employee's remuneration which is excluded from 'wages' by section 1426 (a) (1) differ from the benefits (or benefits and corresponding contributions) based on employees' remuneration not so excluded, or differ because of any retirement benefits available to employees under any retirement plan created or authorized under State or Federal law."

(4) The heading of section 23 (p) of the Internal Revenue Code as amended by the bill reads: "(p) Compensation paid for personal services under a trust, annuity, or deferred payment plan." Section 23 (p) relates to deductions allowed the employer. It is the contributions of the employer to the trust, annuity, or deferred payment plan with which section 23 (p) deals. These contributions may be held in trust and accumulated for the employees or they may be applied to purchase annuity or other benefits for the employees. Such contributions have not been treated as compensation under the Internal Revenue Code nor under various other existing Federal laws. We believe that the intent of the subsection would be clearer if the words "compensation paid for personal serv-

fees" in its heading (p. 113, line 9, of the House bill) were struck out and the words "employer's contributions" substituted therefor. This will require corresponding changes in the wording of this subsection on pages 113, 114, and 115 of the House bill. For instance, the first sentence (p. 113, line 12 ff) might be made to read:

"Employer's contributions paid or accrued on account of his employees under a stock-bonus, pension, profit-sharing, or annuity plan, or similar plan shall not be deductible, etc."

(5) An employer who enters into a group annuity contract with an insurance company in order to provide pensions for his employees frequently purchases past service annuities (say, 1 percent of salary for each year of past service) in addition to the annuities provided with respect to current service. Both employer and employees usually contribute to the cost of the current service annuities but almost invariably the employer pays the entire cost of the past service annuities, which are frequently on a lower basis, expressed in terms of percentage of salary and length of service, than the current service annuities. The payment for the past service annuities may be a single payment made at the time the annuity contract is issued. One of the reasons for the limitation on the deductibility of an employer's contributions from income which is proposed to be made by section 23 (p) (1) (A) of the bill is to prevent an employer from taking the entire cost of the past service annuities as a deduction in 1 or 2 years. With that intention our committee is in sympathy. We are not making any recommendation as to the percentage of compensation which an employer should be allowed to deduct in a single year, as that point has been fully covered by other witnesses who appeared before the Senate Committee on Finance at the hearing on July 31. We do, however, believe that the restriction in the House bill is too drastic and trust that the Senate Committee on Finance will give careful consideration to the views on this point expressed by Mr. Forster and some of the other witnesses at the hearing who spoke in regard to it.

(6) The cost of annuities varies, of course, in accordance with the age of the annuitant at the time the contract is purchased and at the age at which retirement will occur. Obviously, if a pension plan contemplates that all annuities will start at age 65 and will all be based on the same percentage of the respective salaries of employees for whom they are purchased, the employer is going to have to pay a much larger sum to purchase an annuity for an employee who is 63 at the time the contract is made than for an employee who is then 43. We believe that it is the intent of the House bill that the employer shall be allowed a deduction not in excess of 5 percent of the aggregate compensation to all the persons who are included in the plan, and not that the limitation shall be applied with respect to the compensation of each individual. In order that this may be made entirely clear we suggest that the words "any employee" in line 14 on page 113 be changed to "his employees" (see par. 4, supra) and that line 24 on page 113 and lines 1 to 4, inclusive, on page 114 of the House bill be changed to read:

"* * * of ____ per centum of the aggregate compensation otherwise paid or accrued during the taxable year to all the persons who are beneficiaries of the trust. The excess of the employer's contributions in such taxable year over such ____ per centum shall be deductible in equal * * *."

If this change is made, then the same change should be made in lines 11 to 17, inclusive, on page 115 of the House bill.

Of course, if the suggestions made by other witnesses at the hearing that the employer be allowed to deduct the full amount of current service annuity cost plus a percentage of the cost of past service annuities in any one taxable year should be adopted, the language we are suggesting would not be appropriate. In any event, we feel that the percentage of deduction allowed should be related to the aggregate compensation of all employees covered under the plan rather than to the compensation of each individual. There is no danger in this from the standpoint of discrimination among the individual employees, since that point will be taken care of by section 165 (a).

(7) The House bill proposes to add a provision relating to the taxation of employees' annuities to section 22 (b) (2) of the Internal Revenue Code (see pp. 117 and 118 of the House bill). This new provision requires that if an annuity contract is purchased by an employer for an employee not in accordance with a plan which would meet the requirements of section 165 (a), and if the employee's right under the contract is nonforfeitable except for failure to pay future pre-

miums, the amount paid by the employer for such annuity contract shall be included in the income of the employee in the year in which the amount is paid. It also provides that if the employee's right changes from forfeitable to nonforfeitable, the amount paid by the employer shall be included in the income of the employee in the year in which the change occurs.

It is not improbable that some employers now have pension plans in effect which they will be unable or unwilling to bring within the requirements of section 165 (a). The employer may therefore drop the plan entirely. The rights of the employees may thereupon become fixed or unforfeitable. It is not unusual for a group annuity contract to provide that an employee's right to that portion of the annuity purchased by an employer's contributions will terminate upon termination of employment while the contract is being continued, but that the employee's right to the annuity purchased by employer's contributions becomes fixed on discontinuance of the contract by the employer. Many contracts also provide that the employee's right becomes fixed irrespective of the continuation of employment after he has been covered under the plan for a certain number of years. If for any reason a plan including provisions such as those just described was not eligible under section 165 (a), and if the employer decided that he could not change the plan so as to make it eligible, it appears to us that section 22 (b) (2) (B) of the bill would make the employees covered under the plan subject to income tax for 1942 or some subsequent year on all the payments theretofore made by the employer on their behalf. This would, we believe, be true, notwithstanding subsection (d) of section 144 of the bill, which states that the amendments shall be applicable only with respect to taxable years beginning after December 31, 1941, because it would be in 1942 or thereafter that the employee's rights become nonforfeitable. The inclusion in the 1942 income of an employee of the accumulated payments made by the employer over a period of years might easily result in his financial ruin, and we feel sure that this was not a result intended by the draftsman of the House bill. To avoid this result, we suggest adding at the end of subparagraph 22 (b) (2) (B) the following new sentence, "The two preceding sentences shall apply only to amounts paid by the employer after the date of enactment of this act."

(8) Subsection (d) of section 144 of the House bill (pp. 118 and 119 of the bill) provides that a plan in existence on the date of enactment of the act shall be considered as satisfying the requirements of section 165 (a) for the first taxable year to which that subsection as amended is applicable if the plan satisfied such requirements by the last day of such taxable year. This apparently applies to the taxable status of both employer and employees. It is probable that the revenue bill of 1942 will not be finally enacted until some time in the fall, which would give a very limited time for a nonconforming plan to be brought into conformity with section 165 (a), as amended. In order to bring many nonconforming plans within the requirements of section 165 (a) it will be necessary to have changes approved not only by the directors of an employer corporation but by the stockholders, and in some instances by regulatory bodies. The consent of the individuals covered under the plan will in some instances have to be obtained in order for the required changes to be effective. New contracts or trust agreements will have to be prepared or existing ones amended. It will be difficult, if not impossible, for an insurance company, which might have to work simultaneously on a great many contracts purchased from it by different employers, to make the necessary changes within the time required by the House bill. Moreover, many such amended plans will require the approval of the Commissioner of Internal Revenue as to compliance. We therefore strongly recommend that the words "for the first taxable year" in lines 2 and 3 on page 119 of the House bill be changed to read "for the whole of the first two taxable years" and that the words "forming a part of the plan by the last day of such first taxable year satisfy such requirements" by changed to read "forming a part of the plan satisfy such requirements by the last day of such first taxable year or within 1 year after enactment of this act, whichever is later."

There are two more points with which our committee is concerned. The first of these is whether sections 165 (a) (1) and (2) are intended to apply to group annuity contracts. We feel they are not, but if they are we believe clarification of the language is necessary. The other is with respect to clarification of the meaning of the words "forfeitable" and "nonforfeitable" where they occur in several places in section 144 of the bill. We trust both these matters will have the careful consideration of your committee and that we may have permission, should we find it desirable, to submit specific suggestions with respect to them.

If the subcommittee of the Senate Finance Committee which has been appointed to give consideration to Section 144 of the House bill desires further discussion of any of the points mentioned in this letter, or of any other point in connection with the application of that section to group annuity plans, I and other members of our committee will be glad to furnish any assistance within our power and to come to Washington for further discussion, if that is desired.

Respectfully yours,

HENRY S. BEERS,

Chairman, Special Committee of the Association of Life Insurance Presidents.

STATEMENT OF H. WALTER FORSTER, PRESIDENT OF TOWERS, PERRIN, FORSTER & CROSBY, INC., PHILADELPHIA, PA.

The CHAIRMAN. Mr. Forster, you may give your name and business connections to the reporter.

Mr. FORSTER. I am H. Walter Forster, president of Towers, Perrin, Forster & Crosby, Inc., of Philadelphia, one of whose divisions has acted in a consulting capacity in relation to pension, profit-sharing, and employee insurance plans for over 25 years. We have helped scores of corporations establish such plans, covering several hundred thousand employees. These plans vary greatly in character, and cover, I believe, about every type which is socially and economically sound.

The revenue bill of 1942, section 144, changes substantially the provisions of law governing the tax treatment of pension, stock bonus, and profit-sharing plans. I would like to raise four specific objections to those provisions of the bill, viz:

(1) The limitations on the amount deductible by the employer are unsound.

(2) The employer is denied the right provided for under the present law to recover any portion of his contributions in excess of all liabilities under the plan.

(3) The bill does not provide adequate time within which to conform existing plans to the proposed requirements.

(4) Stock bonus and profit-sharing plans must under the bill comply with the standards prescribed for pension plans, although they are radically different in character.

I shall now take up each of these points.

1. *Limitation of employer deductions.*—Under the provisions of the House bill, the employer's deduction for contributions to a pension plan or trust is limited to 5 percent of the eligible employees' compensation; any payment in excess of such 5 percent must be spread over 5 years. This is a wholly arbitrary limitation which is contrary to sound pension practice and is not necessary in the interest of the revenue.

Under existing law, the contributions made by an employer to a pension trust attributable to current services are deductible in full in the year made; contributions made to such a trust to cover past services are deductible over a 10-year period. Where the employer purchases annuities for the employees directly from an insurance company, the amounts paid by the employer both for past and current services are deductible in the year paid.

Obviously, annuity plans at present have an advantage over pension trusts, since the past service contributions are deductible in full in the

case of an annuity plan while such contributions have to be spread over 10 years in the case of a pension trust.

The Treasury proposal of March 23, 1942, was designed to equalize the treatment between these two types of plans by providing that, whether an annuity plan or a pension trust was involved, the employer should get a current deduction for the amount actuarially required to meet his current liabilities, and that any excess was to be deducted over a 5-year period. A 5-percent limitation was suggested merely as a "rule of thumb," and represented the amount which would be allowed in any case as a current deduction without having the employer prove the necessity for it by actuarial computations.

However, the House bill adopted the 5-percent limitation without also adopting the Treasury proposal permitting the taxpayer to deduct the full amount of his proved current liabilities. Thus, as the bill now stands, an artificial limitation has been imposed, which has absolutely no significance taxwise or from a pension standpoint.

Moreover, a limitation of 5 percent, or any other fixed percentage, will discriminate against many plans. Some plans cost more than others, (*a*) because the industry involved—as airlines—requires a younger retirement age, (*b*) because the average age of the employees involved is higher, or (*c*) because there is a greater proportion of women than men. Under many plans, therefore, the employer's current cost is substantially in excess of 5 percent of the eligible employees' compensation. For these and similar reasons there is no percentage which can be fixed as a proper maximum deduction for all situations, and adopting an arbitrary limitation may result in such a hardship as to necessitate reducing benefits or even discontinuing plans.

The requirement of a 5-year spread of any contribution in excess of 5 percent will also discourage companies from adopting plans or continuing existing plans. For example, assume an employer has to pay into his plan in 1942 for current services 10 percent of his pay roll, or $100,000. Based on the 5-percent limitation, he would be permitted to deduct $50,000 of that amount in that year. Based on the rule requiring a 5-year spread, he is permitted to have an additional deduction in that year of $10,000 (being one-fifth of the excess $50,000). On the $40,000 not allowed as a deduction, this year, the employer will have to pay a tax of approximately $36,000 (assuming a 90-percent rate). This means that the employer must spend $136,000 this year in order to put $100,000 into a pension plan for the exclusive benefit of his employees. It is obvious what the effect of such a limitation will be upon the creation of new plans and the continuation of existing plans.

Furthermore, an employer will be reluctant to pay out money now and have the deduction for some portion of that deferred for as much as 4 years in the future, when there is no assurance that he will have profits in such future years against which to take the deduction.

For these reasons, I suggest that the provisions of the House bill be modified so that, first, the employer will be entitled to a deduction in the current year for the full amount contributed to take care of his liability for current services, which is permitted under existing law, and has not given rise to any difficulties, and that, second, the employer be allowed in addition to charge off in full in any year an

amount not in excess of one-fifth of his total liability for past services.

2. *Recovery of unnecessary reserves.*—Section 165 of the Internal Revenue Code gives a trust tax deferred status if—

> * * * it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees, * * *

Under this provision, the employer could recover any reserves if a plan is terminated and if its assets are in excess of those required to satisfy all liabilities under it. Of course the employer, having been allowed a tax credit on the money paid in, would have to pay a tax on the money recovered.

The present bill eliminates the provision permitting the employer to recover any portion of the funds in excess of his liability under the plan. This change is highly undesirable. It is impossible on sound pension plan financing to avoid the possibility of excess reserves. This is true whether a plan is insured, or its assets are invested by a trustee. Such financing must always be made against future contingencies. Employees may die faster than anticipated. They may leave service more rapidly than assumed. Capital gains and interest may increase the assets beyond those required.

There is no social disadvantage of tax impropriety in continuing the present provision permitting the recovery of unnecessary reserves (*a*) so long as the contributions are limited to reasonable actuarial requirements for promised benefits, (*b*) so long as the only amount which can be recovered is that which is in excess of the liabilities under the plan, and (*c*) so long as the recovery will be subject to tax in the hands of the employer.

3. *Time to conform to requirements.*—This bill gives an employer until the end of his first taxable year under the Revenue Act of 1942, within which to conform existing plans to the requirements of the new bill. This will not give many employers sufficient time in which to make the necessary changes. For example, this bill will probably not become law until September. If the taxpayer is on the calendar-year basis, he will have 3 months in which to conform his plan. But many plans will require amendments of irrevocable trust instruments which will necessitate securing the consents of thousands of employees and possibly invoking the jurisdiction of local courts. Others will necessitate the revision of highly intricate annuity contracts, again with the consent of the participants in the plan as well as the insurance companies. Action by the board of directors, and approval by stockholders, will have to be obtained in most instances. All this could not be done within the time allowed.

The 1938 Revenue Act allowed the taxpayer until the end of 1939 to conform to the irrevocability requirements in section 165. This was later extended to the end of 1940. Yet that was a relatively simple matter compared to the changes the new law will require of many existing plans. Accordingly, I suggest that the taxpayer be given more time and have until the end of 1943 to qualify under the 1942 law.

4. *Stock-bonus and profit-sharing plans.*—While the eligibility and nondiscrimination provisions of the House bill are generally workable for pension plans, the same type of limitation is wholly inappli-

cable to stock-bonus and profit-sharing plans, since such plans serve a basically different purpose. Pension plans are intended primarily to clear the pay roll of old and inefficient employees. Stock-bonus and profit-sharing plans, on the other hand, are designed to provide employees, particularly those who are in a position to influence profits, with a substantial incentive to introduce original ideas and improvements and to resist competitive offers of employment which, today, is a very important matter. In effect, such plans may be said to adjust the compensation of employees whose true value to the business is not accurately determinable in advance of the appearance of the results of the year's operations.

To distribute the amounts credited to each employee under a profit-sharing plan entirely in cash is highly undesirable——

Senator TAFT (interposing). He will not get much if he raises his salary.

Mr. FORSTER. That is true, particularly those in the higher wage brackets. I feel that vigorously.

To distribute the amounts credited to each employee under a profit-sharing plan entirely in cash is highly undesirable, because this encourages gearing the employees' standard of living to extraordinary distributions rather than to fixed salary, and because such cash payments have an inflationary effect. These disadvantages are eliminated if such contributions are put into a trust which defers the benefits. Thus instead of receiving the very irregular income which would arise from the cash distributions, the eligible employees are enabled to enjoy a comparatively stable income during their working years, and at the same time to make some provision for income after their earnings decline or disappear.

To conform with the eligibility and nondiscrimination requirements of the House bill would prevent profit-sharing plans from serving the purposes for which they are intended; which Mr. Sturtevant covered in a very excellent manner. On the other hand, if such plans do not conform to the requirements of section 165, they cannot be continued because the employees would be taxed currently on payments, the receipt of which is deferred. Employees would have to pay out of their regular earnings income tax upon the deferred benefits, which is impractical at present rates.

Moreover, the application of the 5-percent limitation to profit-sharing plans is obviously impractical. A profit-sharing plan is adopted in many instances by companies which have fluctuating earnings; thus distributions are made only in good years. To require such a company to carry over any portion of an amount in excess of 5 percent conflicts with the purpose of adopting such a plan, since it will require postponing the deduction for profits earned in good years to years when profits are low or nonexistent.

My suggestion therefore is (*a*) that the present provisions regarding eligibility and nondiscrimination be restricted to pension plans and trusts; (*b*) that a new section be written covering stock bonus and profit-sharing plans, in which appropriate restrictions can be inserted preventing the distribution of dividends to stockholders through the guise of a profit-sharing plan; and (*c*) that the existing provisions of section 23 (a), limiting the deduction to reasonable compensation, be used to prevent excessive distributions to officers or other highly compensated employees in connection with profit-sharing plans.

Conclusions.—My conclusions may be summarized as follows:

(1) Taxpayers should be permitted to deduct in full the amount contributed by them each year to a pension plan or trust to cover current services. This is permitted under existing law and was included in the Treasury's proposal of March 23. No sound reason exists for its elimination in the House bill. Taxpayers should also be allowed to charge off in any one year an amount not in excess of one-fifth of their total liability for past services. As suggested by the Treasury, this should be applicable to both pension trusts and annuity plans.

(2) Taxpayers should be permitted to recover amounts contributed to a plan or trust which prove in excess of the actuarial requirements under the plan. This is the provision of existing law, and sufficient safeguards exist to prevent the use of this provision for tax-avoidance purposes.

(3) Taxpayers should have until the end of 1943 within which to conform existing plans and trusts to the requirements of the new law.

(4) Finally, unless this committee wishes to see the elimination of, or a substantial reduction in the benefits under, profit-sharing plans, such plans should not be subjected to the wholly unrelated criteria established for pension plans.

Thank you very much for this opportunity to be heard.

The CHAIRMAN. Thank you, sir.

Mr. FORSTER. Are there any questions that I can answer, sir?

The CHAIRMAN. No questions by any member of the committee. Thank you.

Mr. Hansen.

STATEMENT OF ARTHUR S. HANSEN, CONSULTING ACTUARY, CHICAGO, ILL.

Mr. HANSEN. Mr. Chairman, my name is Arthur S. Hansen, of Chicago, Ill., conulting actuary specializing in employee benefit plans. I do not sell insurance or investments. For the past 15 years, except for teaching, as professor of economics, I have been doing research and professional work on the subject of pension and profit-sharing plans. The work included group and individual plans, insured and trusteed plans, plans for different types of concerns, e. g., railroads, banks, retail, and so on. I had the privilege of being the actuary for the subcommittee of this committee some years ago on profit sharing. I had access to all the data of the many hundreds of plans submitted at that time.

I appear in my own behalf, and in the interest generally of my clients, and I would hope that I can supply some information in view of the experience I have had with these particular plans.

The Treasury has a stated objective to reduce the possibilities of tax avoidance and abuse. This seems to be the main reason for the consideration of this subject at this time.

The present bill is somewhat different from the proposals of the Treasury. It has some desirable features and does, to some extent,

accomplish the stated desires of the Treasury. There are many problems yet to be solved, however, in the proposed language. For my purposes the problems fall into two categories: First, those affecting the typical pension plan, and, secondly, those affecting the incentive profit-sharing plan.

The subject is involved and technical. I shall now cover only the major policy problems. If you wish, later I can submit additional material on the details, rather than taking the time here, except by way of answering questions.

As a little preamble, it might be a good idea to clearly distinguish between the types of plans. There is a hybrid between the pension and profit-sharing plan which makes it confusing and difficult to separate the two types of plans.

There are two possible types of objectives: One is security of the employee in old age, or upon the happening of certain contingencies; the other objective is one of incentive for production or accomplishment. A pension plan basically has for its objective security, and the contributions are usually fixed either in amount or by the benefits promised by the plan in order to accomplish the security objective.

We have in recent years acquired a hybrid which we might call a profit-sharing pension plan, namely, a plan where the objective is still security of the employee after retirement, or other contingencies, but in which the contributions are based upon the profits of the company rather than becoming fixed obligations. That type of plan is, of course, particularly desirable for companies having fluctuating earnings, that are not in a position to obligate themselves to fixed charges, but yet who wish to provide for the security of employees. That plan, incidentally, is sometimes called a pension plan and sometimes called a profit-sharing plan, depending on whether you are looking at the benefits or the mode in which the contributions are made.

Then we have what might properly be called a profit-sharing plan. That is the one having for its objective the incentive of production, or cost savings, and of course the source of contributions in such case would always be profits.

The limited study that we have been able to make in the time we have had since the bill has been out has indicated the following problems: I have listed here nine specific items, some of which have been previously covered by other speakers. I will discuss each one briefly, so as to get into the record the particular items with which we are concerned. The discussion will be abbreviated as much as possible. These nine items affect the pension plans only.

First, we have discrimination. As Mr. Beers has already said, discrimination appears in two places, first in eligibility and, second, in amount. The language differs from the proposal of the Treasury, and from the language in the report. In one of these instances it appears as though the language as it now stands does not, in language, indicate what was intended by the report or even by the Treasury. It is very necessary to have some particular definition of what "discrimination" is.

Now, that involves two things: First, the language, and, second, the matter of policy, as to how far discrimination should be permitted.

The question was raised by the Senator as to what is the difference between "discrimination" and "reasonable." The difference, as I see it, is that discrimination, as used in this bill, is a new word that has never occurred in this connection before in any legislation. "Reasonable" is a word which has been in the revenue laws for many years and has an entire body of rules, regulations, and law behind it. Now, if we could get "discrimination" defined, as well as "reasonableness," it would be satisfactory, but as it stands there are all kinds of possibilities as to what is meant by discrimination.

Provision is also made for having two trusts as part of one plan. The question of discrimination, the application of discrimination, rises immediately. If you have two plans there must be some discrimination, otherwise there would be no necessity for having two plans. So, we have, in one sense, a contradiction in that the law provides for two trusts in one plan and yet it says there should be no discrimination.

There are a host of other things, such as: In one plan we may bring to retirement one group of employees at 60 and another at 65. They may both receive the same dollar benefits, they may both receive the same percentage of salary, but the values of such benefits will be greatly different. Is that discrimination, because the values of the benefits are different? Or if we had the other case where the values of the benefits were the same, would it be discrimination if the amounts were different?

We have, of course, the next problem, the second item, which is forfeiture and nonforfeiture. We have two additional words that are brought in here. We have the same type of situation in that we must have some concise information as to what is meant by forfeiture and nonforfeiture. I think Mr. Beers covered that subject very well. He said, in general, that we should have at least some general standards. I think that is absolutely necessary, in order for any person confronted with this bill to be able to interpret the intention or the policy of the legislature.

The third item is that of recapture. This has also been covered by previous speakers. The present language would require an amendment of practically all of the existing plans. This would require time. In all of the plans having fixed benefits it will be necessary to make actuarial forecasts. It is impossible to know exactly what amounts will be required. In the event of liquidation, change, or termination, if we have this provision it would be necessary to distribute small surpluses that might remain, as a technical result of actuarial estimates, to all of the participants, whereas with the recapture clause it would eliminate such necessity and simply provide for reversion to some one place.

The fourth item is time for adjustment. That has also been discussed before. In order to just accomplish the change in this recapture clause it may be necessary for stockholders to approve, it may be necessary for the court to approve. That takes time, and I think consideration should be given to the extension of time allowed for compliance.

At this moment I am discussing types of problems involved, rather than suggesting means or policies which might be used for taking care of them.

The fifth item would be the division into parts. If a company has more than one plan, as was generally interpreted from the discussions in the House, they would be considered as a whole. The language of this bill, however, is such that only parts which are of the pension type can be considered together, and only parts which are of the profit-sharing type can be considered together. In other words, if the company had a pension plan for a large group of employees and a profit-sharing plan for a small group, they could not be considered together because they are two different types. That may be simply an oversight, but it is something which is very important and must be taken into consideration.

We also, at this point, collide again with the discrimination. It is practically impossible to have more than one plan if we are not to have discrimination.

The sixth item is the 5-percent limitation. That has been discussed by several previous speakers. Apparently it looks like an oversight in the drafting. They left out the provision providing for an amount in excess of 5 percent if the actuarial requirements indicate it is needed.

As it stands now, it is 5 percent. This was intended as a minimum, to eliminate work to prove the right to a deduction, but would become the maximum, because no one would feel that they wished to contribute more than 5 percent if it might be subject to a tax.

The seventh item is one which has not been discussed before, and that is it might be possible under this language to have duplicate taxation. If a plan meets section 165, there seems to be no problem. If the plan does not meet section 165, there is a problem. If the benefits are nonforfeitable, which we still have not interpreted, then there would be no tax to the employer but the employee would be taxed.

Then we have the third category where we have a forfeitable plan which does not qualify. Under that the employer would be taxed apparently in the year in which the contribution was made, but in one of the other provisions the employee would also be taxed when he received a nonforfeitable right. That is another technicality which, of course, must be straightened out.

The eighth point is a problem which has been raised before. That is the matter of beneficiaries. The language should be broadened to include the possibility of payments to beneficiaries as well as to employees without jeopardizing the possibility of qualifying.

The ninth point is one which was discussed in the House, but seemed to have gotten lost somewhere. That is the attempt to eliminate the discrimination between the different types of carriers handling these problems. At the present time the language appears to have eliminated, as Mr. Forster said, the difference between insured and trustee plans, but there is another type of organization known as the mutual benefit association that has not been considered. At the present time there are discriminations against employees' mutual benefit associations. In other words, under a trust or an insured contract the employer receives a tax advantage which is not available to these mutual benefit associations. A very simple addition to section 101 (16) would take care of that. I think it is important that this subject also be brought in, so that we have a uniform treatment of all plans.

These mutual benefit associations generally are made up of employees. They do not have officers who receive salaries and traveling expenses to come down here and appear before you and, as a result, very little has been heard from them.

Senator TAFT. Just how do they work?

Mr. HANSEN. Ordinarily a group of employees of a particular employer form an association, not for profit but for the purpose of providing benefits for themselves in the event of death or disability. Sometimes they carry a cash value, sometimes retirement or unemployment, and so forth.

Senator CONNALLY. Under the statute are not some of those mutual benefit associations exempted?

Mr. HANSEN. Under the statute they are exempted provided 85 percent of the contributions come from the employees. In other words if an employer had an insurance contract to give disability benefits to the employees, where the employer paid 100 percent, it would be a taxable deduction. If, however, the employer pays even 15 percent for the same purposes into one of these associations, the association becomes taxable. That section of the law should be amended.

Senator CONNALLY. That is not confined to the really mutual company?

Mr. HANSEN. Originally, I think that was the intention; but I think in view of these other things and the attempt to equalize between types of carriers, that we can still maintain the mutuality and still not discriminate against that particular form. As it stands now, the answer is, these associations will eventually be forced out of existence, because they cannot take any contributions from the employer because of the tax situation. A very simple two-word insertion would amend the present law and would make the tax basis comparable with that of other types of plan.

These foregoing nine points apply to pension and security plans. The profit-sharing plans require a different consideration. I have a number of comments here which I will submit for the consideration of the committee.

It seems as though the Treasury has not had time to consider the profit-sharing aspect of this problem. Section 165 originally covered profit-sharing and pension plans. The abuses which have arisen have apparently been mostly in pension plans. As the result, the Treasury has devoted most of its time to the consideration of that type of plan. There has been relatively little consideration given to profit sharing. We do have, of course, the results of the profit-sharing survey of this subcommittee in 1939. Without going into all the conclusions, I will simply give a few of the current problems with which we are faced on this particular bill. If any of you have questions on the survey I will try to answer them.

The objectives of the profit-sharing plan are to produce efficiency, to reduce costs, as distinguished from the objective of a pension plan which is security. The payments in a profit-sharing plan must be discriminatory if they are to accomplish the objectives of a profit-sharing plan. The only criteria which we have been able to find up to the present time, which seem to be applicable to profit-sharing plans, would be a reasonableness of the total amount paid to the

individual; that is, adding the actual cash salary to the amount all the rules which the Internal Revenue Bureau now must use, and has been using for years, we have a test which will stand.

The next portion of the test will be that the percentage of the total which is allowed to be deferred should be limited. In other words, it should not be made possible for a person to defer 90 percent of his salary.

Then the third provision which might be added is some specific limitation to take care of the disguised dividend. In other words, some specific limitation to officers who might normally participate in an incentive plan based upon their stockholding, so there is no possibility of concealing a dividend.

Those tests, I say, would be sufficient to take care of an adequate profit-sharing plan. The proposed bill would require practically a liquidation of all incentive profit-sharing plans. They could not qualify under the eligibility, under the discrimination, under the 5-percent provision and several others. Employers could not afford to make nondeductible disbursements in high-tax years. The present bill practically would result in a complete liquidation of that type of plan.

The result of that liquidation, or the result of the prevention of new plans, would be, first, the lack of incentive when today particularly it is so badly needed for our war production; and, secondly, it would result in cash bonuses as distinguished from deferred payments, which would lead to inflation and all the necessary things that follow.

At the present time, as has been previously stated, the United States is probably the most important stockholder in the country. It receives most of the profits. If we look at the United States then as a manager of the business, since it is a participant, good business principles would at least require the consideration of the matter of incentives. In other words, you are the board of directors, in effect, of the large corporation. It is the business of the United States. As such a board you should, as each one of these individual boards would do, look into the possibilities of incentive taxation.

As I said, there are three types of plans before us. I am talking only about this third incentive plan now. As I have said, it would be ruled out. The tax savings, by ruling out this particular type of plan, would be negligible in proportion to the benefits which the employer, in this case the United States, would receive. In other words, we might save a few dollars in taxes by eliminating this type of plan, but in doing that we might increase cost of operation, we might decrease efficiency of operation to such an extent that the cost would rise; we would have more inflation possibilities; the materials that we need for war would be delayed; the costs which the Government would have to pay for these materials would be increased. You can see that the possibilities there are many times the possibilities of the few dollars of tax savings which might be obtained.

This is a matter of policy which you, as the board of directors of the business of the United States, have to decide. I am merely presenting the problems which are facing you.

An individual with a possible anticipation of increased profits from his own effort is more than likely to respond and produce. That has

been, in a sense, the basis of our economy in this country since we started. We have progressed beyond other countries because we have permitted individual initiative to be provided for. Now, if we are to squelch that, particularly at this time, we may have a very serious effect on our war production.

There are, of course, numerous examples of the savings of pennies and loss of dollars. I think the Jewel Tea Co. had specific figures for you this morning. There are many others that could be brought out. At the present time, we have a very definite demand for incentive. We have had the illustration this morning of the War Production Board asking for increased efficiency. Perhaps the incentive plan might increase efficiency many thousandfold over the tax savings that might be obtained, by not ruling out the few dollars which a few people might get under the plan.

The profit-sharing advantages, I might say, are advantages in a depression as well as at the present time. The results of the profit-sharing survey were printed in 1939. The survey started in 1937. The information applied particularly in the years 1934, 1935, and 1936. We had at that time conditions completely reversed, in a sense, to those existing now. We were then trying to get more people back to work, we were trying to make jobs. At the present time we have the reverse situation, and yet the conclusions at that time were that profit sharing was desirable just as it is now.

In view of our production problems at the present time, it seems to me that profit-sharing plans are doubly desirable. A profit-sharing plan is not something which is merely a temporary war measure, although it will presumably help, but it is also satisfactory in the depression period afterward. We need a tendency, as has been previously stated, to level out, to give the people in the years when we need their extra effort the incentive to produce and to allow them to carry some of the gains over to depression years when they are needed.

The profit-sharing survey arrived at two conclusions. They were both very positive. The first was exemption from all income taxes of payments to employees from accumulated profit-sharing retirement funds. That is even beyond what is being considered here for qualifying pension plans. The second was the issue and sale of the United States Government profit-sharing bonds available only for profit-sharing funds when used for the protection of profit-sharing fund investments. The substance being that these bonds were to have a somewhat higher yield than the average, which, in a sense, would be a subsidy to industry for creating such a plan.

Senator BROWN. How large a committee was that?

Mr. HANSEN. The subcommittee consisted of the chairman, Senator Herring, and Senators Vandenberg and Johnson.

Senator DANAHER. Is it a Senate document?

Mr. HANSEN. It is a Senate resolution, Seventy-sixth Congress. This is the committee print—610 is the number.

Senator BROWN. About 2 or 3 years ago?

Mr. HANSEN. 1939.

In conclusion we have recommendations of the Treasury which are, of course, attempting to accomplish an objective. In so doing they affect other things which they had not completely studied. Here we have, in a sense, the only report on the subject which, up to

now, has received practically no consideration. We spent practically 2 months in hearings right in this very room, listening to people like Gerard Swope, Edsel Ford, and men of that type, discussing this matter. All the industry of the country at that time was brought in. We have the facts and the conclusions in these reports. At the present time we have a situation where there is practically no recognition given to those conclusions. The conclusions at the present time, which are not specific but which inherently involve the same result, are absolutely diametrically opposed to the conclusions of all of that work, and even if you modify the conclusions which are very specific, you still have a situation completely different from the result which you will get under the present bill.

At the present time, there is no other statute on the books which will encourage efficiency of production. Every other statute is bringing down the production of individuals. Everybody is worrying about the tax that he is going to have to pay. They say: "What is the use of working any harder, because we get nothing out of it anyway."

Here is one place where, if we could continue profit sharing, we would have something that these people could say is worth working for. Patriotism is fine, but we need, in addition to that, these personal incentives. If you provide such incentives, the loss of revenue will be negligible; the results in increased production should be well worth any loss in revenue.

In conclusion, considering the two types of problems, it seems to me that we have the problem of fixing the language and the details in regard to a pension plan; and, secondly, we have the problem of the necessity of making a special provision for profit-sharing plans. As I have indicated before, I think a test of reasonableness, with a limitation on the percentage deferred, and a limitation to stockholders, would be satisfactory requirements for profit-sharing plans. Such plans are desirable and should not be eliminated as they provide the incentive which we so badly need now, and will leave satisfactory plans after the inflation of the war.

The CHAIRMAN. Thank you very much, Mr. Hansen.

Mr. Goldstein.

STATEMENT OF MEYER M. GOLDSTEIN, DIRECTOR, PENSION PLANNING CO., NEW YORK, N. Y.

Mr. GOLDSTEIN. Mr. Chairman, I will make this very brief. I am Meyer M. Goldstein. I am director of the Pension Planning Co., but I am here as a member of the law and legislation committee of the National Association of Life Underwriters, which consists of life-insurance underwriters throughout the United States, in all the cities and States.

The proposed 5 percent provision is the sole one to which I will confine my remarks.

Having worked for many months with the Treasury Department, and having appeared before the Ways and Means Committee, we felt that a magnificent job had been done in developing the highly technical subject of pension plans, and therefore we want to address ourselves to this 5 percent and 5-year provision.

I might also say that Mr. Beers, representing as he did this morning the group-annuity companies, has covered that. I can delete from my testimony that portion which would deal with group annuities, which also interests our members, since they sell both group annuities and individual policy pension trusts. I shall confine my remarks just to the individual policy pension trusts.

That is the type of plan whereby individual policies are put into a trust, the same type of policies that you or I might buy from the same insurance company, except that in this instance the employer makes a contribution toward the plan.

Now, then, taking that type of plan and considering it, we find that it represents a different aspect in the financing of it as compared to the typical group annuity plan. So the proposal of the House bill has introduced two new principles. The first one is that there is no longer any distinction between future and past services in the financing of a plan, it has all been merged into one. You take your 5 percent, no matter how you figure it, and then the excess you prorate over 5 years.

The second deviation from the principle is that an arbitrary figure of 5 percent has been introduced, and then some excess prorated over a 5-year period.

Now, ever since the beginning of the pension trust provisions, this distinction between future services and past services has been in the statute, repeatedly kept in there, repeatedly administered by the Revenue Department. To the best of my knowledge, no claims arose to the effect that this was such a terribly difficult administrative job. So that from the viewpoint of the Treasury we had this distinction between past and future services: From the point of view of the employer it represented a perfectly natural distinction, because at the time you establish a new plan you have two problems: One is to start a process so that you will not repeat the mistakes of the past in not having had a plan. So you say you are going to deposit enough money between the time a man enters the plan and the normal retirement age to finance his retirement benefit. In other words, if he is 45 years of age and he retires at 65, over 20 years you deposit the actuarial sum required. That is your future service and current service cost.

Then the employer, when he starts the plan, has a group of employees who served the company faithfully for many years. He has one man aged 64, another man aged 60, another man aged 59, another 53, and so on down the line, so unless you establish some benefit in recognition of past services you get the effect where you are failing to reward and recognize the value and faithfulness of those employees who have contributed to bring the business to the very point where it is possible to establish a pension plan, and you would not be able to get the people off the pay roll because you would not have any money to do it with unless you set up the special fund.

Now, the major source of tax loss to the Revenue Department has been a perfectly legal tax avoidance whereby under the laws as they have existed up to now the group annuity, for example, could measure the total accrued liability for past services and deduct it all in 1 year. So if it ran into a million dollars they could deduct the million dollars, and if it would be $2,000,000 they could deduct the $2,000,000.

Then having financed their total past service accrued liability at the time they installed the plan, from that time on all they would have to treat with would be the future service cost. So the Treasury Department said: "We cannot afford to allow that any more, because that comes off the high corporate brackets. We want to spread it out over 5 years." That viewpoint the National Association of Life Underwriters is in perfect agreement with, because it was a form of favoritism to the life-insurance type of contract as distinguished from the self-administered pension trust of the Bell Telephone type that one of the gentlemen mentioned. So now they are doing this on a uniform basis, and we are in complete agreement with that principle.

Senator TAFT. The difficulty of it, as I see it, you say everything over 5 percent has to be spread over 5 years, but it may take 10 percent all the time from now until 50 years from now, or 30 years from now, in order to make up this back stuff. It seems to me you ought to be allowed to deduct what you actually pay this year. I agree you ought not to have to pay this year to make up all the back stuff, but what you pay this year, the whole 10 percent, it seems to me, ought to be deducted.

Mr. GOLDSTEIN. That is positively right, sir. That is the way we think about it.

Senator TAFT. It does not say the 5 percent is for past services spread over 5 years, it says you have got to take the 5 percent extra and figure that over 5 years, but next year you are going to pay 10 percent again. I do not see the reason for the wording relating to one-fifth.

Mr. GOLDSTEIN. My opinion is that the reason is an administrative one, and my opinion seems to be backed up by a quotation from the report itself. It says, in the amendment to section 23 (p), "It has been decided that in the interest of clarification and administration of the tax laws no deductions should be allowable," and then they describe this 5 percent and 5 years. Our point is that that is not at all necessary or wise, to introduce this arbitrary 5 percent and the arbitrary 5 years.

First dealing with the 5 percent as related to current costs, 5 percent is worse than arbitrary. It is not adequate. Other speakers have demonstrated the same thing. We have made some studies, which we will not bore you with, but it is common sense that you get differences in various types of businesses. Some have an older age group, and having an older age group they automatically have to get rid of that unusual burden.

The important thing is the past service liability is nonrecurring. Once you fund your past service liability you are through with it. A company that in 1936 established a group annuity plan might have paid all of their past service liability in full in the year 1936, or they might have paid it over the 5 years through 1941 and then they are through, for never will they have that problem coming up again, because from that point on every time a new employee becomes eligible they begin to fund his benefits. So all you would have to have is something that we have always had, for 20 years in the law; that is, we would have a fair actuarial basis to fund the future costs that would be fully deductible this year.

As to the past services, the old principle was to pay it in 1 year, but the new principle is a 5-year spread, which we are in complete favor of, with one exception, we feel that in the interest of small and medium size business units, anything that is deductible, within limits that are desirable from the Government standpoint, should be deductible in full in the year of deposit. Let me give you an example. If the past service accrued liability were $100,000, $20,000 would be the maximum that would be deductible in any one year, so if that company were in a position to deposit $20,000, they would get the deduction for $20,000. And another year, when they are able to deposit another $20,000 they would get that deduction. Of course, if they only deposited $15,000, they would only get a deduction for $15,000. So they whittled away that $100,000 accrued liability for past services as fast as they could, consistent with the ceiling that we recommend, that should not be more than 20 percent deductible for any one year, 20 percent of this accrued liability for past services.

From the standpoint of social good we ought to be very grateful in this country that we have the type of tax law that we have had for the past 20 years, because having it we have a more impregnable position for the three or four million people who are now covered by pension plans. In other words, all of these companies that have established these plans, and have set up the funds to take care of the accrued liability for past services, those companies' pension plans have all been made financially stronger. Those employees are fully protected now because that past-service money is in there and they are covered from this point on. All they have to do is meet the current costs.

Now, what we want in the tax system is a plan, it seems to us, which will continue to encourage employers to pay up their past service liability as quickly as possible, to make the plan impregnable in bad times. The only limit we are putting in is a practical one, that we do not want them to take it off their top brackets all in 1 year. The new revenue act would say, "You can put in as much as you want, but we will only allow you a deduction not to exceed one-fifth of the accrued liability for past services in any one year. In addition to that, we allow you full deduction for the future service liability."

Senator DANAHER. That is a new slant on pensions. It's too bad we didn't have some explanation like that when the pension for Congress was up.

Mr. GOLDSTEIN. Well, sir, there was never anything that was more misunderstood than that was.

I believe that is sufficient for my testimony. Thank you, gentlemen.

The CHAIRMAN. Thank you, Mr. Goldstein.

Mr. Maduro.

STATEMENT OF DENIS B. MADURO, NEW YORK, N. Y., COUNSEL FOR NATIONAL ASSOCIATION OF LIFE INSURANCE UNDERWRITERS

Mr. MADURO. My name is Denis B. Maduro. I am an attorney at law in New York City. I am here today in my capacity as counsel for the National Association of Life Insurance Underwriters, which is an organization of approximately 33,000 life underwriters in the

country. I do not in any way, in my views, represent any of the views of the life-insurance companies. This is the agency force.

The only point that I will discuss this morning will be the point on the 5-percent limitation contained in the pension statute. The reason why I will discuss only that one point is because, in my opinion, if that is not cured the rest of the amendments regarding pension trusts become academic. They become academic because it would be absolutely impossible for many pension trusts in existence today to continue, or for many future pension trusts to be inaugurated.

I think the limitation of 5 percent is quite unreasonable, and the effect which has been discussed by the other witnesses this morning has been the effect upon the employer.

As a representative of the National Association of Life Insurance Underwriters, I would like to point out the effect upon the employee beneficiary of the pension plans and their respective beneficiaries, or their appointees who benefit by those plans. They represent some two or three or four million of employees in the country plus their beneficiaries.

The first effect of this small limitation would be to prevent the inclusion in pension plans of employee benefits which are socially and economically desirable and limit them, if they are continued, to inaugurating the smallest types of benefits.

The second effect upon the employee beneficiaries would be to cause a great many existing plans either to terminate or to eliminate these desirable employee benefits.

The third effect upon the employee beneficiaries would be to force the employees to contribute to those plans to which they are not now contributing, or to make additional contributions to those plans to which they are now contributing, and to force employees to make contributions to it under present circumstances and conditions at a time when they are least able to afford any more deductions from their pay.

The fourth effect upon the employee beneficiaries of this 5-percent limitation would be to limit pensions to the employees of those companies which have a large working capital, and to deprive the employees of companies with a small working capital from the benefit of pension plans which, in my opinion, is an unfair discrimination.

Some of the witnesses have stated that the 5-percent provision is too small. Well, why is it too small? What will 5 percent of the pay roll purchase today? After all, if 5 percent of the pay roll will purchase 100-percent benefit to employees it is not too small. So our inquiry directly is: What will 5 percent of the pay roll purchase in pension benefits? Well, the cost of pension benefits depends entirely upon the age of the participant involved, the exact benefits to be given to him, and the type of investment to be obtained to accomplish those benefits.

Let us assume the most limited benefit plan from the point of view of the employee beneficiaries. That is a plan where the employee upon retirement if he lives to retirement and if he is with the company at the age of retirement will receive his pension only for the period of time for which he lives. If he dies before retirement his beneficiaries will receive nothing. If he dies after his retirement his beneficiaries receive nothing. If he severs employment with the corporation after 15 or 20 or 25 years of service he receives nothing.

Assuming the most limited type of pension benefit, the one benefit of life income only in the event of retirement, and taking the average weighted age of most of the plans, we find 5 percent of pay roll can purchase approximately 7½ percent of salary as a retirement pension. Remember that will be 7½ percent of salary as a retirement pension on the most limited type of benefit. No death benefit in the event of death before retirement; no death benefit in the event of death after retirement, whether it is one month or two months after retirement; no benefits whatsoever in the event the employee, after many, many years of service, terminates employment with the company before the age of retirement, but on the most limited type of pension benefits, 5 percent of salary under the average weighted age of most plans will purchase approximately 7½ percent of salary as a pension at age 65.

The answer may be, "Well, why not make the employee contribute more?" As I have stated in one of my statements on the effect upon employees, today your employees are not in a position to contribute more money from pay roll for any purposes. They are having deductions from pay roll necessarily for the purpose of their war bonds; they have deductions, or will have deductions probably, for future income taxes; they are having deductions for social-security benefits and unemployment; they have various amounts of deductions and those deductions may run anywhere from 20 to 30 or 40 percent or more.

If corporations cannot deduct the full current liability of their costs or their contributions to pension plans and then necessarily they are either going to discontinue them or they are going to reduce the benefits to the smallest amount of benefits, or they are going to force employee contributions.

The reduction of benefits in the plan to the most limited benefit type of plan will not result in all the benefits that the other witnesses spoke about, in regard to the economic relations between employer and employee. If it is attempted to give the employee certain incentives for the purpose of creating good will, extra work, if those incentives are not brought about then the contrary result is obtained, as far as his efficiency is concerned.

If the amount of the current liability of the corporation or employer for a pension contribution is not deductible in full, then, in my opinion, there may be objections to it, even if the corporation wants to continue the plan in existence. There may be objections from stockholders, there may be objections from the employees themselves, and there certainly will be objections from those who stand in a creditor position, not in the case where there is insolvency, but from those organizations which advanced credit to an organization of this type.

One thing that I would like to comment on, which has been brought out by the testimony of some of the other witnesses, is their figures as to the actual percentage of pay roll that companies are now paying for their contributions to the pension plan. They were limiting themselves to the contributory plan; they were not discussing the noncontributory plan where the corporation bears the entire cost. So that those figures that refer to the contributory plan should be doubled for the many cases of pension plans where the employer is paying the entire cost, and undoubtedly in view of the present status of the employees' pay roll, the noncontributory plan has

got to be the plan from now on and into the future. Many corporations wanting to adopt a plan today cannot ask their employees to make contributions, they have got to make contributions in their entirety. There are already in existence a tremendous number of the noncontributory plans. So the figures cited as to what the present corporations contribute, the ratio of that to the pay roll, does not apply in the cases of those corporations which have the noncontributory plans. They practically should be doubled.

In closing, my alternative for the provisions regarding the 5-percent limitation is that the only fair provision is to allow a corporation to deduct its current liability under the pension plan. That current liability, under the pension plan, in my opinion, does not depend upon how much is there for past services, or how much is there for future services. The current liability is the obligation of the corporation under the plan to make a certain amount of contributions to accomplish the benefits of the plan. I do not care whether past-service or future-service formulas are used, or whether they are merged or not. There is an easy calculation to determine that current liability under the plan, the amount that you should pay this year in order to have a certain amount of money at a future time to provide benefits under that plan.

Senator CONNALLY. Would there be any of them saying: "Well, we will make a lot of profits this year so we will pay a lot this year, and then we will slow down; we will pay so much"?

Mr. MADURO. That will be impossible, sir; because of the fact that the current liability will be set forth and limit current deductions.

Senator CONNALLY. There has to be some time limitation as to when that plan is adopted. They might adopt a new plan.

Mr. MADURO. That would not make any difference.

Senator CONNALLY. A plan adopted prior to January 1, 1942, or 1941?

Mr. MADURO. Yes. I personally do not think it makes any difference when the plan is adopted.

Senator TAFT. You would not want to permit the company to make up its back liability in 1 year.

Mr. MADURO. No, no; that is not a very desirable feature. But deposits for a reserve would be desirable.

Senator TAFT. I do not think you can let them make up the whole back payment in 1 year.

Mr. MADURO. No.

Senator TAFT. You will have to spread that over 5 years, as suggested.

Mr. MADURO. I think spread over 5 years would be absolutely fair and reasonable, sir, for a general reserve in excess of current liability.

My last comment on this suggestion of mine: There is no possibility of having such a provision as allowing a full deduction for the current liability result in any tax avoidance, because of the fact that the previous part of the bill already contains provisions which limit pension plans to only those which are sound and desirable pension plans. I do not believe that any pension plan can qualify under the qualifications of the bill except that which is sound and is a reasonable pension plan, and having established the fact that it is a sound and reasonable one then, in my opinion, the corporation should be allowed a deduction

for its contribution equal to its current obligation or liability under the plan.

Thank you, sir.

The CHAIRMAN. Thank you.

Mr. Duhig.

STATEMENT OF STANLEY W. DUHIG, VICE PRESIDENT AND TREASURER, SHELL UNION OIL CORPORATION, NEW YORK, N. Y.

Mr. DUHIG. My name is Stanley W. Duhig. I am vice president and treasurer of the Shell Union Oil Corporation. It seems to me that the committee might be interested in hearing the experience of one individual taxpayer under these proposals in this new bill.

The Shell Union Oil Corporation and affiliated companies constitute an employer group which maintains an employees' pension plan and a savings fund covering several thousand members. The Shell companies are deeply concerned over some of the proposals which are contained in the present printing of the 1942 revenue bill, H. R. 7378. We believe that the Senate Finance Committee will be interested in some practical examples of how these revenue act proposals would affect the employee pension and thrift plans maintained by the Shell companies.

The Shell provident fund is an employee savings plan which has been successfully operated in this country for 28 years and now has a membership of approximately 9,000 employees. The present trust was organized in September 1939 to include only employees in the United States. Membership is offered to a class of employees consisting of clerical or salaried employees as distinguished from employees paid on an hourly wage basis. Ninety-two percent of the members, which includes the management, earn less than $5,000 per annum. The employee contributes to this savings plan a percentage, usually 10 percent, of his pay and the employing company matches that contribution. The employee has a vested interest in the company's contribution after he has had 5 years of service.

The Shell pension plan became effective January 1, 1938, and covers all of the employees in the United States and Canada, numbering about 27,000. The employees make no contribution. The employing companies at present contribute 5.6 percent of pay roll to the pension trust, which is administered by a board of trustees. Individual employees do not have a vested interest until reaching retirement age. Full pension amounts to 40 percent of pay, subject to some offsets for social-security and provident-fund contributions, and is payable at age 55 for women and age 60 for men.

Senator CONNALLY. Is there a requirement for a certain minimum period of employment?

Mr. DUHIG. Yes, sir; 20 years.

Senator CONNALLY. You have a pension for any man age 60?

Mr. DUHIG. What we call a partial pension, if he has been with us 15 years, provided he is 60 years old.

Both of these funds qualify under section 165 of the present revenue act as employee funds whose earnings are not subject to tax.

If we have correctly interpreted the tax proposals they would permit the companies to deduct from taxable income 5 percent of the pay

rolls for persons who are members of these two employee groups. The contribution in excess of 5 percent could be deducted from taxable income, if any, over a period of 60 months. The Shell situation at the present time is, in round figures, as follows:

Ten-percent contributions to the provident fund, approximately $2,500,000 per annum; and the 5.6 percent to the pension fund approximately $3,500,000 per annum. Total contributions deductible under the present tax law, $6,000,000 per annum.

On a total pay roll of approximately $60,000,000 per annum, the present aggregate contribution is about 10 percent and the new law would permit the following allowable deductions in the present year:

Pension contribution—5 percent of pay roll, $3,000,000; one-fifth of additional pension contribution, $100,000; one-fifth of provident fund contribution, $500,000; allowable deduction for 1942, $3,600,000. $3,600,000 subtracted from $6,000,000 gives us a remainder to be spread over succeeding 4 years of $2,400,000.

Thus only 60 percent of the companies' contribution would be allowable as a deduction this year. The remaining 40 percent, which would be disallowed, would amount to $2,400,000, and while, of the eight or nine companies in the group, some will be in excess-profits-tax brackets and others will not, it may safely be assumed that it will cost the companies additional taxes this year at the rate of 50 percent, or a tax of $1,200,000 in 1942. It is doubtful whether some of these companies will ever be in a position to take deduction for their share of the expense. It is more than possible that all of them will run into loss years, which will deprive them of this legitimate deduction of an expense which is being incurred at the present time solely for the benefit of these employees.

We submit that the 5-percent limit on deductibility is purely arbitrary. It discourages the setting up of sound plans.

The Shell pension plan is economically operated and has suffered no investment losses, yet on careful actuarial analysis it requires 5.6 percent contribution even on the assumption that its investments will earn 3 percent per annum, which is not a conservative assumption at the present time. Two other reasons why it can operate on a contribution of as little as 5.6 percent in the United States are that there is in the plan provision for (*a*) offsetting against the pension the amount of Federal old-age benefit—our plan calls for 8.2 percent in Canada, where the Social Security Act does not apply—and (*b*) reducing the pension by a percentage of the amount contributed by the companies to the provident fund. Thus it would not be sufficient for the Shell companies to cut out the contribution to the provident fund—which is under serious discussion—because the pension fund cost would then jump to nearly 10 percent and we would be faced with drastic reduction in pensions or abandoning the plan altogether.

Senator TAFT. If you abandoned the plan, would not you be faced probably by an immediate 10 percent increase in wages to make up for it, current wages?

Mr. DUHIG. Yes, sir.

Senator TAFT. The War Labor Board would give it to them.

Mr. DUHIG. Possibly; which would be quite inflationary, of course. At the present time the man contributes 10 percent of his own pay, which means he only gets 90 percent pay on his pay check. If we did

what you suggest, abandon the plan and put the 10 percent for contributions on his check, he would have not 10 percent but 20 percent increase to spend. A man at the present time making $300 a month gets $270, because he is contributing 10 percent. If we did add 10 percent to his pay, instead of contributing to the savings fund, he would get a check for $330 instead of $270, which, of course, is an inflationary item, as you suggest.

Now, the 5-year spread of the excess over 5 percent is also a purely arbitrary period of time. Its only excuse can be that it provides more immediate revenue to the Treasury by pushing off some of the deduction on a pyramiding scale over 5 years time. This is unsound because unfair to the taxpayer in not permitting him current deduction for current expense, and very likely it can be unfair to the Treasury if tax rates continue to rise during the next few years.

It should certainly be possible to deal more realistically with regular, permanent, and legitimate employee plans. To cause the taxpayer to abandon such plans is not only a disservice to the thousands of wage earners but also removes an important antiinflationary medium. As an illustration of this, the Shell trusts have to invest, including the employees' provident-fund contributions, over $8,000,000 per annum. This has been and will continue to be very largely invested in United States Treasury securities.

That is my brief statement, Mr. Chairman. If you have any questions, I would be glad to answer them.

The CHAIRMAN. Are there any questions?

Thank you very much for appearing.

(The following communications were ordered inserted in the record:)

MASSACHUSETTS MUTUAL LIFE INSURANCE CO.,
Detroit, Mich., July 29, 1942.

Hon. WALTER F. GEORGE,
Chairman, Finance Committee, United States Senate,
Washington, D. C.

Re amendment to section 23 (p) as contained in proposed revenue bill of 1942.

MY DEAR SENATOR: I wish to call your attention to the amendment to section 23 (p) as proposed in H. R. 7378 relating to deductions for contributions made by an employer to a pension trust.

Under the present law, contributions made by an employer to a pension trust qualifying under section 165 are covered under section 23 (a) and section 23 (p), as follows:

Contributions covering the current year's pension liability, and which, together with other compensation, do not constitute unreasonable compensation, are deductible in the year paid into the trust, as a regular and normal business expense, under section 23 (a).

Contributions in excess of the current year's pension laibility are deductible over a period of 10 consecutive years under section 23 (p).

The action of the House Ways and Means Committee in changing this 10-year period to five years and applying it to all deferred compensation plans, including direct purchases of annuities by the employer, etc., seems to be well taken and, I believe, meets with the approval of all who are interested in bona fide pension plans which are set up for the benefit of employees and not for the purpose of obtaining special tax exemptions.

The amendment, however, eliminates any deduction by the employer under section 23 (a) and provides that all such deductions be made under the provisions of section 23 (p), as amended.

The amendment to section 23 (p) provides that amounts paid into a trust that is exempt under section 165 (a) shall be deductible "only in the year

when paid into the trust, and in an amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries of the trust. The excess over 5 percent of the amounts so paid is deductible in equal parts over a period of 60 consecutive months beginning with the first month of the year in which such payment is made."

Thus the House bill arbitrarily fixes the "current year's pension liability" which is now deductible under section 23 (a), at 5 percent of the compensation otherwise paid.

Specific objection.—The fixing of the "current year's pension liability" is an actuarial computation based upon (1) employee's age, (2) age at which pension is to begin, (3) amount of pension.

It has been the expressed desire of the Congress to encourage private pension plans for employees, plans which are bona fide and not set up for purposes of evading taxes. The provisions of section 165 are such as to properly eliminate any tax advantages where such plans do not qualify as bona fide. Therefore, it is my contention that an employer who sets up a bona fide plan should be permitted to deduct the current cost of such a plan in the year in which the cost is actually incurred and the "current year's pension liability" is just as much a business expense of that year as a proper charge for depreciation on machinery.

Roughly speaking, 5 percent of an employee's salary will provide a monthly retirement benefit at age 65 of—

37 percent if he enters the plan at age 20.
24 percent if he enters the plan at age 30.
14 percent if he enters the plan at age 40.
7 percent if he enters the plan at age 50.

With employees being confronted with social security taxes, increased income taxes, bond purchases, etc., the tendency is definitely toward larger contributions by employers and smaller contributions by employees. In an increasing number of cases the employer feels that the entire pension cost should be paid by him and considered a business expense as would be the case if no plan were adopted but employees were simply pensioned at a certain percentage of their salary when reaching retirement age. Any amendment to the law which discourages employer contributions to plans which have qualified as being within the spirit and letter of section 165 would seem to be contrary to the desire of the Congress and the administration in otherwise encouraging bona fide pension plans.

Therefore, may I express to you my well-considered conviction that—

(1) the "current year's pension liability" not be replaced by an arbitrary and untrue amount of 5 percent of compensation.

or

(2) If, in the interests of clarification and simplicity of administration of the law, a fixed percentage of compensation be desirable, that the percentage be raised to at least 10 percent, which, on an average basis, would provide approximately a 28 percent pension at age 65 if the average age of employees entering the plan was 40.

I am also writing to Senator Arthur H. Vandenberg and Senator Prentiss M. Brown in this connection as I feel that the inclusion of this amendment as it now stands is not in the interest of the employer, the employees, or the Treasury Department. Your consideration of the matter will be greatly appreciated by those who have the true interests of all three at heart.

Sincerely,

E. LEIGH JONES,
Manager, Pension Trust Department,
George E. Lackey Agency.

OAKLAND, CALIF.,
July 30, 1942.

SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMAN: Enclosed is a plan which I am submitting as a substitute for national compulsory savings now being discussed. I have arbitrarily computed the special tax, if any, due on salaries of different amounts of both single and

married persons. Item 1 could be broadened to also include net incomes from business or professions, dividends, interest, and other miscellaneous income.

This plan may have already been conceived of by our tax experts; however, I have not heard or read of a similar plan and request that you give it your fullest consideration.

It is imperative that the sale of war bonds be on as near a pro rata basis as possible and that this war be financed as much as can be by the sale of bonds to individuals and not by demands on banks for loans to the Government.

This special tax is, of course, in addition to the regular tax and should be incorporated in the 1942 income-tax forms. It should solve compulsory savings plan which is considered absolutely essential for the duration of the war and will act as a very effective curb on inflation as well as financing the war to a great extent.

Everyone I have shown this plan to has agreed that it is a fair and equitable one. Even persons who admitted that they haven't purchased any war bonds and state that they should have were very much in favor of such an addition to the new tax bill. Personally I will have to purchase additional bonds to avoid the payment of this special tax.

I know of only one large defense plant in the San Francisco Bay area that is making a regular deduction from employees' pay checks for the purchase of war bonds. Many of the defense workers in other plants are buying their share of war bonds, but the majority is not.

Due to the uncertainties ahead of us the purchase of war bonds must be on a pro rata basis. It is definitely out of alinement at the present time. The enclosed plan will remedy this and furnish the Treasury Department and Congress data on which to base future tax laws.

The importance of such a measure is so great I know you will give this your sincere consideration. I will appreciate it very much if you will please acknowledge receipt of this letter.

Sincerely yours,

ROBERT E. PEYTON.

cc. Hon. Henry Morgenthau, Jr.
cc. Senator Sheridan Downey.

Special tax as a substitute for compulsory savings

SINGLE PERSON

Item						
1	Salaries and other compensation for personal services	$1,500	$3,000	$10,000	$17,500	$30,000
2	Taxable income 10 percent	150	300	1,000	1,750	3,000
3	Less:					
	Personal exemption	$75	$50			
	War bonds purchased	75	250	$1,000	$1,500	$2,500
		150	300	1,000	1,500	2,500
4	Balance subject to tax				250	500
5	Tax (50 percent of item 4)				125	250

MARRIED PERSON

Item						
1	Salaries and other compensation for personal services		$3,000	$10,000	$17,500	$30,000
2	Taxable income 10 percent		300	1,000	1,750	3,000
3	Less:					
	Personal exemption		$150	$150	$300	$750
	Credit for dependents			50		100
	War bonds purchased		150	750	1,500	2,000
			300	950	1,800	2,850
4	Balance subject to tax			50		150
5	Tax (50 percent of item 4)			25		75

EXEMPTIONS

	Amount of exemption
Single person, earnings:	
To $3,000	$75
$3,001 to $5,000	50
Over $5,000	None
Married person, earnings:	
To $10,000	150
$10,001 to $15,000	250
$15,001 to $20,000	300
$20,001 to $25,000	500
Over $25,000	750

Any person (single or married) purchasing war bonds totaling $15,000 or more is exempt from this special tax. Service men, with the exception of commissioned officers, are exempt from this tax.

Mr. Conboy.

STATEMENT OF MARTIN CONBOY, OF CONBOY, HEWITT, O'BRIEN & BOARDMAN, NEW YORK, N. Y.

The CHAIRMAN. All right, Mr. Conboy, you may proceed.

Mr. CONBOY. So far as my appearance is concerned, I presume you want, first of all, for me to give my name and representation.

The CHAIRMAN. Yes.

Mr. CONBOY. My name is Martin Conboy, 39 Broadway, New York City; attorney and counselor at law, representing four corporations—the Joy Manufacturing Co., of Franklin, Pa.; the American Sumatra Tobacco Co., of New York City; the United States Plywood Co.; and the Reliance Electric Co., of Cleveland, Ohio. These companies are on what is known as the fiscal-year basis.

My appearance here is in opposition to section 129 of the proposed law which will make fiscal-year companies taxable at the 1942 rates for part of their 1941–42 fiscal year.

The justification for the fiscal-year basis with respect to corporations has been admirably expressed by Mr. Kellogg who appeared before the committee day before yesterday, and there is nothing I think need be added in that respect, with regard to the reason why corporations operate on a fiscal-year basis. The objections to section 129 which contains the proposed changes in the existing law are stated in the memorandum which we have distributed among the members of the committee.

The method of taxing fiscal-year corporations upon an apportionment basis was tried in 1932 and was discarded in 1934 by the Ways and Means Committee because of the complications and difficulties that it created. Those complications and difficulties are indicated in our memorandum and are instanced by cases which are set forth by our authoritative authorities. In addition to the difficulties and complications inherent in such a method, it is unjust and unfair to change the rate by which a corporation is taxed during the tax year itself.

Senator RADCLIFFE. Will you speak a little louder?

Mr. CONBOY. It is manifestly unjust to raise the rate of taxation of a corporation during the year in which the corporation is being taxed, especially where there was no reason to anticipate an increase. The present tax law was passed on September 20, 1941. It contains no suggestion at all that corporations which are being taxed on the

fiscal-year basis were going to have their taxes increased again within the fiscal year. Therefore they went ahead with their business activities and conducted them on the assumption that their taxes would remain at the rate fixed by the 1941 tax law and would not be increased during the period of the fiscal year constituting the tax year. They made their contracts, entered into commitments, borrowed money from banks, and paid out dividends to their stockholders on the assumption that they were going to pay just so much in the way of taxes.

If they did not distribute their surplus in dividends, they were subject to the penalty described by section 102 of the act, and would have to pay an additional amount of tax because of the fact that they accumulated a surplus. They had to make the distribution. Having made the distribution, the stockholders have received the dividends and will be taxed upon the income thus received from the corporation. The Treasury has not lost the taxes on the corporation income, at least to the extent that taxes are received from the stockholders on dividends. If the stockholders received the dividends in the year 1942, they will have to include them in their return for that year and will be taxed at the 1942 rate. Of course, if dividends were received in 1941, they will be taxed as income to the stockholders at the 1941 rate. To treat the corporation's revenue as lost to the Treasury for taxable purposes is not accurate. The Treasury has not lost the chance to tax it.

Senator VANDENBERG. I notice you say on page 3 of your prepared statement that—

> The reasons for the abandonment of the apportionment method are set forth in detail in Paul and Mertens, Law of Federal Income Taxation.

Is that, by any chance, Mr. Randolph Paul?

Mr. CONBOY. That is, by every chance, Mr. Randolph Paul.

Senator VANDENBERG. Well, it is excellent authority.

Mr. CONBOY. That is why it is the bible of the law on Federal income taxation. I appeal to the men who read the bible if that is not so.

As I say, we have fortified our statement with the expression contained in the report of the Committee on Ways and Means, that the complicated rule had to be eliminated for the reasons stated with respect to the 1934 act, and also fortified it by a number of instances justifying the change that the committee made. Now, the committee having made the change, and the change having persisted through the legislation since 1934, corporations were justified in assuming that they could go ahead on that basis for their 1941–42 fiscal year and being so justified, as I say, they made their commitments and have been consistent in doing what they have done.

It may very well be that some corporations have been liquidated after having distributed their surpluses, after having made proper reserves for taxes, on the basis of the 1941 rates. Under the proposed change in the law the stockholders would probably be subjected to an obligation to repay what they have received. But so far as the Treasury is concerned, the Treasury has not lost the opportunity to tax what the corporations have paid out, because, as I have explained, the stockholders have to make their payments on their income-tax returns upon the basis of the rates that are in effect at the time they receive the distributions.

There seems to be very little reason why I should take up more of the time of the committee, in view of the fact that we have set forth our objections in detail in the memorandum which we have submitted.

I have noted it is the appropriate thing for a witness to ask if there are any questions. May I ask that through the chairman?

The CHAIRMAN. Are there any questions by the members of the committee?

Senator CLARK. You do not think it is a fair proposition to change the rules in the middle of the game.

Mr. CONBOY. That certainly is my position. It should not be done, especially when you have led the corporations into acting on the assumption that you are not going to change the rules. It would be unfair to change the rules after you have implicitly represented to the corporations that you are not going to change the rules. You did change them once, but you should not change them again. It seems to me that would be the limit of unfairness.

The CHAIRMAN. Are there any other questions?

Thank you very much.

Senator VANDENBERG. I would like to have a copy of the book.

Mr. CONBOY. If you want all the volumes, I can probably get them for you. I am only quoting from the fourth volume, sir.

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

MEMORANDUM SUBMITTED BY MARTIN CONBOY, NEW YORK, N. Y.

THE PROPOSED REVENUE ACT OF 1942, SECTION 129, FISCAL-YEAR TAXPAYERS

The proposal that taxes at the 1941 and the 1942 rates be levied upon the incomes of taxpayers reporting on a fiscal-year basis for a fiscal year beginning in 1941 and ending in 1942 was first submitted to the Ways and Means Committee of the House of Representatives on June 23, 1942. The provision was incorporated in section 129 of the proposed act. No public hearings were held thereon.

THE PRESENT REVENUE ACT

Under the Internal Revenue Code and the revenue act now in effect (sec. 118, Revenue Act of 1941) and the prior revenue acts of 1940, 1939, 1938, 1936, and 1934, corporations filing returns on a fiscal-year basis have been taxed at the rates applicable to the calendar year in which the fiscal year began.

THE HISTORY OF APPORTIONMENT FOR FISCAL YEARS

Having enacted an income-tax law in 1913, Congress recognized that any change in rates of taxes would raise problems for taxpayers who were reporting on a fiscal-year basis, and inserted in the 1916 act a provision for an apportionment in such a case (1916 act, sec. 10). Subsequently, Congress made similar provisions for apportionment in levying excess-profits taxes. Such provisions were included in the 1918 and subsequent acts, which required all taxpayers to file returns on a fiscal-year basis if their books were kept on that basis.

The method prescribed for the computation of taxes for a fiscal year included in 2 different calendar years has been essentially the same under the subsequent acts to and including the 1932 act. The tax was computed on the total net income for the fiscal year under each act separately, just as though the entire amount of income had been earned under each act. Then the tax computed under each act was allocated to the fiscal year on the basis of the portion of the fiscal year covered by the law under which the particular computation was made. The sum of the two amounts allocated to the particular fiscal year was the tax for that fiscal year.

This method abandoned for the reasons hereinafter stated is revived in the proposed bill.

Under the proposed act of 1942 the tax on the net income of a corporation with a fiscal year beginning in 1941 and ending in 1942, will be pro rated under the 1941 law and the 1942 law as provided therein, in accordance with the number of months of the fiscal year included in each of the calendar years.

We shall consider first the practical objections to the apportionment method and then the effect of its proposed retroactive application to the fiscal year 1941–42.

I. THE OBJECTIONS TO THE APPORTIONMENT METHOD FOR FISCAL-YEAR TAXPAYERS

After a trial of the apportionment method for a number of years substantially as incorporated the Revenue Acts from 1916 to 1932, inclusive, the House Ways and Means Committee in drafting the Revenue Act of 1934, abandoned it.

Reasons for abandonment of the apportionment method, after previous trial.—The Committee on Ways and Means in its report accompanying the proposed 1934 bill stated:

"Under sections 14 and 105 of the Revenue Act of 1932, the tax on such returns was first computed under the provisions and rates of the Revenue Act of 1928 and then under the provisions and rates of the Revenue Act of 1932. The final tax imposed for a fiscal year of 12 months was then found by taking the sum of (1) the same proportion of the tax computed under the Revenue Act of 1928 as the number of months falling in 1931 was to 12 months, and (2) the same proportion of the tax computed under the Revenue Act of 1932 as the number of months falling in 1932 was to 12 months. This complicated rule has been eliminated in the proposed bill for the purpose of simplicity and ease of administration."

The reasons for the abandonment of the apportionment method are set forth in detail in Paul and Mertens, Law of Federal Income Taxation (vol. 4, pp. 621–630).

They show that under the apportionment method, changes in tax rates and administrative procedure presented many perplexing problems for taxpayers reporting on a fiscal-year basis, and cite a number of examples, including complications arising from varying provisions of the different laws governing the taxability of certain transactions, the amounts of credits and exemptions allowed, and the treatment of depletion in the computation of profit or loss.

They discuss a complicated question arising with respect to the filing of a consolidated return by an affiliated group.

A more difficult problem in that respect may be presented by the proposed 1942 act. For example, fiscal-year corporations in an affiliated group have already filed final returns for 1941–42. Each necessarily reported its normal income tax and surtax on a separate return. They will now be required to file new returns for the entire fiscal year. A portion of the tax for the entire period must be first determined "under the law applicable to the first taxable year," that is, the 1941 act. Accordingly it would seem that they must again report their normal income tax and surtax on an individual basis while they may again report their excess-profits tax on a consolidated basis. The other portion of the tax is to be "determined under the law applicable to the second taxable year" except as otherwise provided therein, that is, the 1942 act.

Under section 142 of the new act amending section 141 of the Internal Revenue Code, the members of the affiliated group in making a report for determination "under the law applicable to the second taxable year," will apparently be compelled to file a return on a consolidated basis for normal income tax and surtax in order to continue their previous practice of filing a consolidated excess-profits tax return. It is not clear how the separately determined normal income tax and surtax for each individual company under the law applicable to the first taxable year are to be apportioned with the consolidated normal income tax and surtax of the affiliated group for the second year.

This is merely one indication of the nature of the problems which seem to be inherent in the apportionment method.

While an attempt has been made by the draftsman of the bill to eliminate some of the complications which arose in the administration of the apportionment provision under prior acts, others continue to exist. The many exceptions contained in the new sections 16 and 108 of the Internal Revenue Code will of themselves present difficulties both in preparation of returns by taxpayers and in administration by the Commissioner.

Corporations of moderate size throughout the country which are on a fiscal-year basis will experience great difficulties in preparing their returns, and their

difficulties will be substantially increased by the present shortage of accountants.

While imposing the above-stated hardships upon fiscal-year corporations for the taxable year 1941–42, the proposed act denies to them the benefits of certain of the ameliorating sections designed for the relief of taxpayers, viz: Section 113, which excludes from the income of a taxpayer income representing improvements made by a lessee prior to the expiration of a lease; section 120, with respect to amortizable bond premiums; and section 136, with reference to capital gains and losses.

Paul and Mertens' Law of Federal Income Taxation said of the abandonment of the apportionment method in the 1934 act:

"The difficulty encountered by taxpayers in the computation of taxes for a fiscal year covered by two different laws has been obviated for fiscal years ending during 1934 by the change in the treatment of fiscal-year returns adopted by the 1934 act."

The difficulty so obviated is about to be revived.

II. THE OBJECTIONS TO THE PROPOSED RETROACTIVE EFFECT OF SECTION 129

Reasons for a fiscal year.—Corporations have adopted a fiscal-year basis for various reasons peculiar to the particular industry in which they are engaged. Perhaps one of the most frequent reasons is that they may end their business years and take their inventories in the least active period of their business. Many have fiscal years by reason of the historical accident of the date of their origin. The propriety of doing so has been recognized by Congress in income-tax legislation in the past, and we do not understand that the desirability or propriety thereof is questioned now or that there is any desire or intent to discourage or prohibit the use of the fiscal-year basis or that the proposed section 129 has any such purpose.

The effect of the proposal to make the apportionment retroactive.—The proposal that corporations with a fiscal year beginning in 1941 might be taxed for a portion of that fiscal year at the 1942 calendar-year rates was not even suggested until June 23, 1942, as heretofore stated.

Fiscal-year corporations without reason to expect that the provisions of the 1942 act would be retroactive to fiscal years already ended during the first 5 months of 1942, have prepared and filed Federal returns and paid income taxes and excess-profits taxes for such fiscal years. Both the filing of the returns and the payment of the taxes were required by the existing provisions of the Internal Revenue Code. This action was required to be taken weeks or months prior to the date on which the suggestion that the 1942 act should be retroactive was first suggested (June 22, 1942).

As a result of the retroactive feature of the bill such corporations will be required to file amended returns on an entirely new basis since the 1942 act will also apply to them, imposing an arduous burden both on the taxpayers and on the Treasury Department and resulting in upsetting the calculations which such corporations have made when they closed their books for their fiscal years.

A properly operated corporation must prepare a budget for its coming fiscal year; it must plan its course of action for the year; in doing so its officers must carefully consider and weigh its prospective income against prospective expenditures and taxes. Its proposed course of conduct is weighed in the scale of human wisdom. Corporate officers may naturally be charged with only the probabilities that experience demonstrates should readily be foreseen. The corporate officers naturally forecast the future in the light of their knowledge of the past.

In planning the financial policy for the fiscal year beginning in 1941 and ending in 1942, what could have been reasonably expected with respect to taxation of corporate income

It was perhaps possible that Congress would pass an act before the close of 1941 increasing income and excess profits taxes applicable during the fiscal year. This the corporation, perhaps, should have anticipated. Congress passed the Revenue Act of 1941 on September 20, 1941, increasing the taxes applicable to the corporations' fiscal year ending during 1942.

The corporation might also reasonably have anticipated that during 1942 Congress might make further increases in taxes to be effective for the corporation's fiscal year 1942–43. Its desirable cash position should probably have been determined with that possibility in view. But insofar as the corporate officers might act rationally in relying upon congressional theories and action regulating taxation in the past, the officers would not have had to consider a probability that during 1942 Congress might pass another taxing act further increasing (for

the second time) its income taxes for the fiscal year ending March 31, 1942. The proposed retroactive feature does not impose the duty upon an officer of a corporation with a calendar year of anticipating an increase twice during that tax year. That Congress had in the preceding revenue acts refrained from doing. The congressional conception of just taxation, as heretofore expressed, had not intimated any such possibility which would affect the rest of the fiscal year ending in 1942. There was no conceivable basis for assuming that Congress might do so, even affecting the tax for the uncompleted fiscal year. Here a tax is imposed increasing the taxes for such fiscal year upon many corporations after the fiscal year had been completely closed. With all of the discussions of proposed increase in taxation under the 1942 bill, there had been no intimation that Congress would change its policy in this respect or would adopt a method of apportionment which it had heretofore condemned and discontinued because of administrative difficulties. Valid retroactive taxation had always been of a nature which might have been readily anticipated where not imposed as a deterrent or punishment.

Retroactive taxation has heretofore been retroactive only in the sense that the details had not been determined or the final adoption effected prior to the retroactive period. But such retroactive taxation had always been a matter of consideration and reasonable expectation during the entire time it was to be made effective.

In this instance there has been no intimation, no suggestion, no statement to place corporate officers on notice. The Treasury Department had apparently not considered the proposed retroactive feature desirable. A duty to have anticipated it months ago should not now be imposed upon corporate officers. The suggestion comes as a complete surprise and is not the readily anticipated retroactive taxation which has heretofore been sustained by the courts.

Corporate officers busy with other matters should not be under a duty to imagine and anticipate new or unusual methods of taxation and prepare therefore in advance. This is particularly true at a time when all their efforts should be directed to increasing efficiency and production.

What action have corporate officers naturally taken without reason to expect such retroactive increased taxation for the 1941-42 fiscal year?

1. Fiscal-year corporations have prepared their budgets for the fiscal year 1941-42. They necessarily had to anticipate their income and expenditures for that year. We have seen that they have been under the necessity of anticipating an increase in taxes during the fiscal year, which became an actuality when Congress passed the 1941 Revenue Act on September 20, 1941. We have also seen that they had no reason to have anticipated the present proposed act.

2. Fiscal-year corporations have, accordingly, entered into contracts for purchase of raw materials, made agreements for the sale of manufactured products, completed arrangements for financing their transactions for the year, made promises to repay bank loans during the year, invested money in plant and equipment, all based upon the taxation that they could reasonably be held to have anticipated. Many have begun expansion of their plants which they will have to abandon.

3. Fiscal-year corporations have filed earnings statements of their income with banks and have borrowed money upon the statements of actual income and expenses for part of the fiscal year and anticipated for the remainder. They likewise made their commitments to repay their loans, based upon the estimated net operating income for the year and cash available therefrom, none of which they will be able to meet if the money intended for the repayment of the loans is suddenly and unexpectedly required to pay the unanticipated increase in taxes. The corporation may have repaid the loan and have no cash left with which to pay the taxes.

4. Many fiscal-year corporations after the completion of the fiscal year in 1942, have computed and paid additional incentive compensation to employees upon the net income after taxes, all of which will have been rendered incorrect by the proposed retroactive tax legislation.

These workers will have been substantially overpaid if the Revenue Act of 1942 is made retroactive. The corporation may have no alternative except to bring suits against all such employees to recover the overage or to deduct the same from their wages during this year in which their individual income taxes also will have been increased. It is doubtful if the directors after the expiration of the fiscal year could legally change an additional incentive compensation plan so as to allow the employees to retain that which they received when lawful but now rendered unlawful by congressional act.

5. Pursuant to the requirements of the Securities and Exchange Commission, corporations have filed reports for their fiscal year already ended during 1942, or filed interim reports on the existing tax basis, and the public may have been influenced to purchase their securities on stock exchanges in reliance thereon, all of which reports, although accurately prepared and filed pursuant to congressional requirement, will be made false by the proposed new tax law being made effective in such a retroactive manner.

6. Such corporations have closed their fiscal years, made their final reports pursuant to the Securities and Exchange Commission's requirements in accordance with the congressional intent, and sold new securities to the public on the basis of the reports submitted to the Securities and Exchange Commission but subsequently to be rendered false by the proposed new internal revenue bill.

7. Fiscal-year corporations may have paid three or possibly four quarterly dividends to stockholders out of the net cash remaining from the year's net income without notice or reason to believe that the Government would claim the whole or a part of such cash.

8. Corporations with fiscal years ending on or prior to June 1, 1942, have prepared their 1942–43 budgets anticipating an increase in taxes for the latter fiscal year but without reason to anticipate that they would be deprived of their 1941–42 income by subsequent legislation. They have borrowed money from the banks in reliance upon the year-end statement, about to be rendered false by congressional legislation without notice. They have agreed to repay bank loans during 1942–43, having made such arrangements after anticipating the increase of taxes for the new fiscal year. Many will now be rendered unable to meet their obligations as they mature, because they have paid out their income for the completed fiscal year 1941–42, without any suggestion or reason to believe that Congress would not only reverse its policy enunciated in 1934 but would make said reversal retroactive, even as to those, who upon the completion of a fiscal year, had distributed their income to stockholders pursuant to the policy established by Congress, as evidenced by section 102 of the Internal Revenue Code. They are precisely in the same position in this respect that the calendar year corporations would be if the bill were made retroactive for 1941.

9. These dividends, properly paid out of earnings pursuant to congressional mandate by reason of such unexpected increase in the proposed retroactive taxes may now, as a matter of law, have been paid out of capital, rendering the directors who acted in good faith and without negligence liable to creditors of the corporation for the amounts paid to stockholders. (See *Randall as Trustee of Bush Terminal Co.* v. *Bailey* (decided by Court of Appeals, under sec. 58, New York Stock Corporation Law, New York Law Journal, July 7, 1942).)

10. Corporations by reason of payment of said dividends and the increased income taxes may even be rendered insolvent and unable to carry on the activities of war work or otherwise.

11. Corporations may have been liquidated and, after setting up what then appeared to be proper reserves for taxes, may have distributed their remaining assets to the stockholders.

12. The stockholders although receiving the dividends paid to them pursuant to the congressional mandate contained in section 102 of the Internal Revenue Code in good faith, and having paid to the State and Federal Governments perhaps 30 or 50 percent or more thereof in income taxes on March 15, 1942, may now be compelled to return the whole distribution to the corporation rendered insolvent by the unanticipated increase in the income taxes. (See *United States* v. *McHatton* (266 Fed. 602).)

THE PROPOSED RETROACTIVE FEATURE IS OF AT LEAST DOUBTFUL CONSTITUTIONALITY

The proposed retroactive provision has none of the justifications which have caused some retroactive taxation to be sustained in the past. It has none of the features which were urged to sustain the Silver Purchase Act, in which Government counsel stated in their brief that "The Government recognizes that, even though adopted to make its monetary measures effective, the retroactive act is subject to the limitations of the fifth amendment."

The proposed tax does not fall within the most favorable classification of statutes which have been sustained when contested.

In *United States* v. *Hudson* (299 U. S. 498, 500), the court sustained the Silver Purchase Act for the reasons that "as respects income-tax statutes, it long has been the practice of Congress to make them retroactive for relatively short

periods so as to include profits from transactions consummated while the statute was in the process of enactment or within so much of the calendar year as preceded the enactment."

Neither reason justifies the present proposal. As heretofore seen, it has not been proposed or discussed so as to have been within the contemplation of taxpayers and it has not been limited to the period during which the retroactive feature was in the process of enactment. The retroactive feature does not even impose a tax on the actual income of the portion of the calendar year of the enactment. For companies having fiscal years ending in the first few months of 1942 for the purpose of using the inactive season as a most convenient opportunity for an inventory, their income will have been substantially and may have been entirely earned during 1941. The new tax is not on the portion earned in 1942 but on a fractional proportion for the entire fiscal year.

The proposed provision does not fall within the test suggested as a justification by Mr. Justice Stone, now Chief Justice Stone, in *Milliken* v. *United States* (283 U. S. 15, 20), wherein he said:

"This court has held the taxation of gifts made, and completely vested beyond recall, before the passage of any statute taxing them, to be so palpably arbitrary and unreasonable as to infringe the due-process clause."

And continued, referring to the case of *Nichols* v. *Coolidge* (274 U. S. 531), and *Untermeyer* v. *Anderson* (276 U. S. 440):

"In both the point was stressed, as the basis of decision, that the nature and amount of the tax burden imposed could not have been understood and foreseen by the taxpayer at the time of the particular voluntary act which was made the occasion of the tax."

As we have seen, that is practically the situation here.

And then, in distinguishing the act which he was sustaining, he held (p. 23):

"Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well understood purpose he should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation * * *."

Thus, it is indicated that the retroactive law to be anticipated is one carrying out an established policy, not a law reversing such a policy.

Not only the majority opinion in *Untermeyer* v. *Anderson* (287 U. S. 440), but the dissenting opinion recognized the necessity of justifying a tax made retroactive, and, referring to the majority opinion, Mr. Justice Brandeis said (p. 447):

"It holds the act void because the action of the lawmaking body is in its opinion unreasonable. Tested by the standard of reasonableness commonly adopted by man—use and wont—that action appears to be reasonable."

And again (at p. 449):

"The need of the Government for revenue has hitherto been deemed a sufficient justification for making a tax measure retroactive whenever the imposition seemed consonant with justice and the conditions were not such as would ordinarily involve hardship."

And finally (at p. 451):

"The problem of preventing loss of revenue by transactions intervening between the date when legislation is introduced and its final enactment, is not a new one; * * *."

Subjected to that test of reasonableness, "use and wont," the present retroactive feature is unfair, unreasonable, and without justification.

The original decision sustaining retroactive taxation *Stockdale* v. *Insurance Company* (20 Wallace 323), was, in effect, based upon the fact that the retroactive feature was only carrying out the congressional intent of a prior tax statute which had been frustrated by a decision of the court.

The proposed retroactive feature is even less justifiable as a social policy. The desirability of legislating retroactively with respect to taxes, for the intervening period between the date of the recommendation and the date of the final effectiveness of the act, does not justify the proposed bill. The value of imposing the tax over the period to prevent unfair speculation after the taxing policy has been announced and before it can be made effective is wholly absent in this case. The necessity of providing revenue between the time that Congress has decided upon a certain policy and the time that it can make that policy effective cannot justify the proposed provision which embraces no such limitations. The principle of retroactive application of an increase in income taxes in accordance with the long-established governmental policy, does not justify the proposed retroactive feature, departing therefrom.

The necessity of taxpayers assuming to a limited extent the increase in the tax during the period of its preparation and which results in carrying out a long-established policy does not justify the necessity of assuming additional increased taxes, resulting from a reversal of such policy and the imposing of unexpected and unanticipated retroactive taxation. Here, as we have seen, the taxpayers had no reason to believe that there would be another increase in income taxes applicable to the fiscal year that had been wholly or substantially concluded. The established policy of the Government had been to the contrary.

In the case of the calendar year corporations, they have been forewarned that the new tax law, although it might not be enacted until late in 1942 will apply to the 1942 earnings and, consequently, there has been an opportunity to set up proper reserves in anticipation thereof, reports have been rendered to stockholders, dividends have been paid, borrowings incurred, contracts made, taxes accrued, and debts amortized, with the full knowledge of the possibility of increased taxes for this year. In other words, they are subjected only to the retroactive features ordinarily to be anticipated, as was the 1941 act for the fiscal year 1941–42 of fiscal-year corporations.

Respectfully submitted.

CONBOY, HEWITT, O'BRIEN & BOARDMAN.

The CHAIRMAN. I have received the following telegram addressed to this committee. The reason for reading it into the record will appear at the end of the message. This telegram is as follows:

LOS ANGELES, CALIF., *July 30, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee, Washington, D. C.:

This association represents over 100 aircraft parts processing companies employing 50,000, all engaged in war production. Many of these companies cannot survive and production suffers if proposed excess-profits taxation accepted. Typical company produces 10 times invested capital important aircraft production each year. Base period experience clause useless to many who are losing money, that period developing products which now are essential. Under these circumstances, intelligent management will earn the $10,000 exemption plus 8 percent capital within first month. If profits from remaining millions of production are taxed 90 percent excess, 40 percent normal, plus State and local, with inherent risk in any such business, it would be necessary profit 50 percent gross on sales or 100 percent on cost to result less than 3 percent net on sales. Where will business and capital come from under these conditions? We are speaking now of small business, particularly subcontractors who definitely are not Government financed. Would appreciate this being read to committee for consideration as small business rarely is represented in Washington.

AIRCRAFT PARTS MANUFACTURERS ASSOCIATION,
JACK FROST, *Executive Secretary.*

I think there should be a subcommittee appointed on the subject that has been under discussion this morning. The Treasury is giving further consideration to amendments to the pension trust provision contained in the House bill, and there are certain things that must necessarily be done, and if it is agreeable to the committee I would suggest that a subcommittee of three or four be appointed to confer with the Treasury, and also to represent the viewpoint of the committee in making certain necessary changes in the pension trust provision. If that is agreeable I will be pleased to appoint Senator Brown, Senator Radcliffe, Senator Taft, and Senator Vandenberg, if you will serve, Senator, because you did excellent service on the incentive taxation provision some years ago. I suggest that you gentlemen might confer with the Treasury staff, because the matter is under consideration and there are certain amendments to these sections that undoubtedly will be recommended by the Treasury itself. There may be, and will be, suggestions that the subcommittee will wish to make in behalf of the general committee, because this is an important question.

Senator CONNALLY. Mr. Chairman, I have a statement here prepared by Mr. Robert Ash, a local lawyer, about some tax matter that he has requested that I have inserted in the record. I do not sponsor it, because I do not know much about it, but if agreeable I will put it in the record.

The CHAIRMAN. Yes; if there is no objection, it may be put in the record.

(The statement referred to is as follows:)

STATEMENT SUBMITTED BY ROBERT ASH, WASHINGTON, D. C., ATTORNEY FOR J. E. RILEY INVESTMENT CO.

In the statement made by the Secretary of the Treasury to the Committee on Ways and Means on March 3, 1942, he proposed, as has the Congress itself, that at this session of Congress an attempt be made to eliminate hardships so that the tax laws will cast their burden equitably on all taxpayers. In line with this proposal attention should be directed to one provision of the law which, through misunderstanding of its terms and intent, has imposed hardships on a number of small mining enterprises which, unlike the large mining corporations, did not have adequate legal and tax advisers to protect their interests. The provision in question is section 114 (b) (4) of the Internal Revenue Code providing for percentage depletion.

The Revenue Act of 1932 provided that a taxpayer making a return for 1933 should state whether he elected to have a depletion allowance "for succeeding taxable years" computed with or without percentage depletion.

The 1934 Revenue Act also provided for percentage depletion in respect of mines and specified that a taxpayer making his "first return" thereunder should state whether he elected to take percentage depletion. It was believed by at least some taxpayers (based partly on language in House and Senate committee reports) that this gave a new election to those who had failed to exercise their option under the 1932 act, but that an election made under the 1932 act "for succeeding taxable years" carried through without the necessity for a further election.

The 1936 act continued the percentage depletion provisions of the 1934 act, but gave no new election wherever the 1934 act would have given none.

The difficulties and hardships experienced by some of the small mining companies may be summarized as follows:

(1) Election having been made under the 1932 act to take percentage depletion for 1933 and for succeeding taxable years, certain taxpayers believed they had specifically declared their program and were not obligated again to declare their election under the 1934 act. But it has been held otherwise. (See *C. H. Mead Co.* v. *Commissioner*, 106 F. (2d) 388 (C. C. A. 4), and *Mother Lode Coalition Mines Co.* v. *Commissioner*, 125 F. (2d) —— (C. C. A. 2), decided by Second Circuit February 5, 1942, 1942 Prentice-Hall Tax Service, ¶62,451.)

(2) A taxpayer having no unit depletion basis available and therefore having no choice of methods, attempted to take percentage depletion on the assumption that there being no basis for an election, percentage depletion would be allowed. This was denied on the ground that the taxpayer had a duty to make a declaration. (See *Dorothy Glenn Coal Mining Co.* v. *Commissioner*, 38 B. T. A. 1154; *Tonopah Mining Co.* v. *Commissioner*, 126 F. (2d) —— (C. C. A. 3), decided March 17, 1942, Prentice-Hall Tax Service, ¶62,554).

(3) In another case the taxpayer in a remote part of Alaska did not receive a copy of law or regulations or return forms, and thus had no knowledge of its right to elect percentage depletion for the year 1934. Its return for 1934 was made on the 1933 form and no election was made. Two years later the revenue agent brought the percentage depletion privilege to the taxpayer's attention. The courts denied percentage depletion on the ground that no election was made therefor as required by the statute. (See *J. E. Riley Investment Co.* v. *Commissioner*, 110 F. (2d) 655 (C. C. A. 9), decided March 16, 1940, affirmed 311 U. S. 55 (November 12, 1940)).

(4) The president of the taxpayer, a small coal-mining company, undertook the preparation of the company's 1934 return and sought advice from and relied upon the Deputy Collector of Internal Revenue in preparing and filing the return which included no election of percentage depletion. The Board of Tax Appeals disallowed the percentage depletion deduction because of the taxpayer's failure to

make the new election. *Midvale Coal Co.* v. *Commissioner*, B. T. A. Memo. Op., Docket No. 91729, decision entered July 20, 1939.

(5) The taxpayer had a loss in 1934 and since percentage depletion could only be computed if there was a profit no percentage depletion was claimed. One circuit court denied percentage depletion for 1935 (*Mother Lode Coalition Mines Co.* v. *Commissioner*, 125 F. (2d) 657 (C. C. A. 2), decided February 5, 1942, 1942 Prentice-Hall Tax Service, ¶62,451), on the ground that no election was specified in 1934; and another circuit court allowed depletion for 1935. (*Pittston-Duryee Coal Co.* v. *Commissioner*, 117 F. (2d) 426 (C. C. A. 3)), decided January 24, 1941, on the ground that no election was required in 1934, since none could be computed in a loss year.

The committee knows that Congress in passing the 1934 act did not intend to deprive any mine owner of the right to percentage depletion, but to extend the privilege to those who had failed to avail themselves of it under the 1932 act. (See H. Rept. No. 704, 73d Cong., 2d sess., p. 29; S. Rept. No. 558, 73d Cong., 2d sess., p. 36; and explanation on House floor, 73d Congressional Record 2922.) Certain it is that the provision was never intended to be a trap for unwary and uninformed small mine owners.

The hardship in these cases arises not so much from the denial of depletion for the year involved in the litigation as from the fact that either (*a*) through misunderstanding of the law by the small taxpayer—which is understandable in so technical a problem—or (*b*) misconception of the law by the Board and courts, or (*c*) in the *Riley case*, through failure for physical reasons to be in position to have any knowledge of the law involved, these relatively small mining companies have been denied percentage depletion for their entire existence after 1934, unless there is remedial legislation. The situations presented by these cases and other similar ones represent an inequity which it appears should be cured—in fact the Supreme Court in its decision in the *Riley Co. case*, cit. supra, recognized the hardship or "strictness" of the provision and suggested that the cure for the hardship was a legislative (not a judicial) function. At page 59 the Court said:

"Petitioner urges that this result will produce a hardship here. It stresses the fact that it had no actual knowledge of the new opportunity afforded it by section 114 (b) (4) of the 1934 act and that equitable considerations should therefore govern. That may be the basis for an appeal to Congress in amelioration of the strictness of that section. But it is no ground for relief by the courts from the rigors of the statutory choice which Congress has provided."

It is hoped the committee will enact the needed relief legislation.

Attached hereto is section 114 (b) (4), with proposed amendments printed in italics, which, if enacted into law, will effectuate the original purpose and intent of Congress and eliminate the present inequity and hardship to small mining companies.

SECTION 114. BASIS FOR DEPRECIATION AND DEPLETION

(b) BASIS FOR DEPLETION.—

* * * * * * *

(4) PERCENTAGE DEPLETION FOR COAL AND METAL MINES AND SULFUR.—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 percent, in the case of metal mines, 15 percent, and, in the case of sulfur mines or deposits, 23 percent, of the gross income from the property during the taxable year, excluding from such gross income the amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for such depletion) from the property. A taxpayer making his first return under this chapter [in respect of a property][1] *in which depletion is claimed in respect of a property for a taxable year beginning after December 31, 1941 (whether or not a return in respect of such property was made for any taxable year beginning prior to January 1, 1942)* shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion *unless*

[1] Omit words in brackets, proposed amendments printed in italics.

percentage depletion shall have been claimed by a taxpayer in his return in respect of the property for a taxable year beginning after December 31, 1933, and before January 1, 1942, and if so claimed percentage depletion shall be allowed for such year or years in which claimed. The method, determined as above, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section. The above right of election shall be subject to the qualification that this paragraph shall, for the purpose of determining whether the method of computing the depletion allowance follows the property, be considered a continuation of section 114 (b) (4) of the Revenue Act of 1934, 48 Stat. 710, and the Revenue Act of 1936, 49 Stat. 1686, and the Revenue Act of 1938, 52 Stat. 494, and as giving no new election in cases where either of such sections would, if applied, give no new election *but a claim for percentage depletion in a return for any taxable year after December 31, 1933, and before January 1, 1942, as hereinabove specified shall be held to have been a proper election.*

The CHAIRMAN. Senator Danaher, if you wish to offer for the record the brief which you submtited to me earlier in the morning, this would be the time for it.

Senator DANAHER. I would like very much to do so, Mr. Chairman, and with that an accompanying letter from Mr. Samuel Ferguson, president of the Hartford Electric Light Co., dated July 24, 1942.

The CHAIRMAN. I have looked at the brief, and I think it warrants reading by every member of the committee, because Mr. Ferguson has made some suggestions—he is not merely content with some criticisms of existing law—and the letter and the brief will be entered in the record.

(The matter referred to is as follows:)

THE HARTFORD ELECTRIC LIGHT CO.,
Hartford, Conn., July 24, 1942.

The Honorable JOHN A. DANAHER,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR DANAHER: Your attention, as a member of the Senate Finance Committee, is called to the attached memo which treats of a disastrous oversight of the House Ways and Means Committee in not differentiating between regulated corporations having a slow capital turn-over and unregulated industrial corporations having a quick turn-over. In the slow category are such corporations as render telephone, gas, electric, and other services[1] where the investment is large and the annual sales amount to only 20 or 25 percent of the capital investment, in contrast to the annual sales of the average industrial which equal or exceed their capital.

For such slow turn-over corporation, the tax bill as recommended by the Ways and Means Committee fails lamentably to meet the specifications of Mr. Morgenthau, when he stated—

"A substantial share of the increased corporation tax should fall on excess profits. Taxes paid from such profits have less disrupting effects on business than taxes which are generally applicable to all corporate earnings irrespective of the rate of return. A tax which absorbs excess profits, still leaves the corporate taxpayer with a sufficient margin of income for dividends and safety.

"On the other hand, a tax which dips too deeply into the incomes of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence.

"* * * At a time like this, I am confident that incorporated business will willingly pay additional taxes which will, after all, leave it in the aggregate about the same amount of income after taxes as during the years before 1940."

In the memo, certain sections cover the questions in general as affecting the

[1] Such as railroads, etc.

electric industry—and in other sections the effect on the electric light company; in section V are various possible suggestions for correction.

Very truly yours,

S. FERGUSON, *President.*

Enclosure.

SECTION I. GENERAL—TAX EFFECT ON THE INDUSTRY

Corporation war taxes as proposed create a most critical situation for utility corporations in contrast to the effect on the ordinary industrial corporation.

The earnings of utility corporations have for years been subject to regulation which has aimed with greater or less success to limit them to an amount not substantially greater than required to attract capital.

With few exceptions the earnings to be found to exist in such of these corporations as are able to pay dividends consequently range from 4 to 8 percent on the cost of the property—plus working capital.

These corporations have a very slow capital turn-over amounting to once in 4 or 5 years in contrast to the much more rapid turn-over of the industrial corporations.

With a 5-year turn-over the net profit, after taxes, must therefore be 30 percent of the gross receipts to equal a 6 percent annual return—five times as large a percent of gross than is required for the same return for a 1 year turn-over industrial. Under the 1941 tax law the net earnings and percent return were reduced from pre-war levels in spite of an increase in gross of 10 to 20 percent. This tended to impair the ability to raise new money even of the senior variety—but the bill now before Congress goes much further and very materially further reduces the return so that a company formerly carrying into the net 30 percent of the gross, now finds itself with only 15 percent or less; or a 3-percent instead of a 6-percent return; this is below that necessary to attract capital where the requirement for a prosperous company is 3 percent interest plus 2 percent sinking fund (total 5 percent) and is, therefore, hopelessly inadequate generally.

If it were not for the constant need of new capital, this reduction in earnings would only constitute a hardship to the investors in the business without harming the general public or the industry's ability to serve war industries; but if the earnings are brought down to below the point which will attract capital it will not be possible to expand to meet the essential and constantly increasing needs of the public. Inasmuch as the public must be served, the only possible means of furnishing such service under such conditions will be by governmental agencies with taxpayers' money. This means that the industry will be taxed out of existance as a private undertaking.

It is futile to think of raising rates to meet the situation as practically all added gross revenue from such a process goes to taxes rather than to net from such increased revenue—first, by the excess-profits tax at a 90 percent rate, and next the deduction of 45 percent of what is left. Any raise in rates of sufficient size to appreciably affect the net profit after taxes must be so high as to defeat its own objective through the diminution of sales to be caused thereby according to the law of diminishing returns.

Example

Assume increase in rates		$100.00
Then—Increase in net before taxes		100.00
Less excess-profits tax	$90.00	
Less income tax	4.50	
		94.50
Then gain in net after taxes		5.50

or differently expressed the customer must be asked to pay $18.25 for each added dollar carried into the net profit after taxes.

A restoration of the excess-profits tax to its former and logical place as a final tax after all other taxes and expenses have been deducted would materially help though not fully rectify the situation. Such shift would increase the credit of 1936-39 earnings since the tax of those years was at a lower level. In the case of The Hartford Electric Light Company, it would furnish earn-

ings sufficient for normal dividends but nothing extra to plow back into the property. In the case of other companies, it will be necessary, generally, to reduce the normal tax as well—either directly or by the allowance of debt-reduction payments and preferred dividends as an expense or by other methods.

SECTION II. GENERAL—TAX EFFECT ON THE INDIVIDUAL

It is common to consider that equity requires the same or greater tax reduction in the income of prosperous corporations than taxes make in the income of individual citizens. This fallacy would seem to come from forgetting the fact that a corporation is only a legal fiction covering a group of individuals.

Congress has carefully determined what shall be the rate of taxation on individuals of each income level. This tax rate is (with slight modification in favor of earned income) fixed as a fair assessment according to the total amount of the income of the individual regardless of its source.

If then the income of the individual is reduced by the failure (on account of taxation) of a corporation to pay dividends, the result is that that part of his income is taxed at 100 percent and only the remaining portion at the statutory rate.

The equity securities of the industry are very widely spread and are favorites among people of small and moderate means for whom Congress has fixed as equitable tax rates of less than 25 percent. The average holding of utility stock in the hands of the public does not exceed a market value of $3,000.

The receipts of any portion of the income of an individual from dividends of corporations is recognized to be attended with the business risk inherent to equity securities but this is no reason for adding the penalty of 100 percent tax on the whole or part of same.

This thought is recognized in Mr. Morgenthau's recommendation to the Ways and Means Committee when he said—

"A substantial share of the increased corporation tax should fall on excess profits. Taxes paid from such profits have less disrupting effects on business than taxes which are generally applicable to all corporate earnings irrespective of the rate of return. A tax which absorbs excess profits still leaves the corporate taxpayer with a sufficient margin of income for dividends and safety."

"On the other hand, a tax which dips too deeply into the incomes of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence.

"* * * At a time like this, I am confident that incorporated business will willingly pay additional taxes, which will, after all, leave it in the aggregate about the same amount of income after taxes as during the years before 1940."

It is to be hoped that the Senate in the interest of the individual utility stockholder will give consideration to the fundamental difference inherent in a regulated slow turn-over corporation as compared to one of quick turn-over and not subject to regulation of earnings, and will save him from the imposition of 100-percent tax on a portion of his income which he would not incur if an equal amount of his income had been derived from bond interest or dividends from unregulated corporations with rapid turn-over.

SECTION III. TAX EFFECT ON THE HARTFORD ELECTRIC LIGHT CO.

The Hartford Electric Light Co.'s earning statement for 1942 is estimated to be as follows:

Receipts		$12,001,485
Less:		
Operating expenses	$5,548,180	
Depreciation expense	768,537	
Taxes (exclusive income and excess-profits tax)	1,017,802	
		7,334,519
Operating income		4,666,966
Other income		157,930
Gross income before Federal taxes		4,824,896
Less interest and depreciation appropriation from surplus		306,000
Available for income and excess-profits taxes and dividend		4,518,896

Less:		
Excess-profits tax (90 percent)	$1,470,723	
Normal income tax (45 percent)	1,168,405	
		$2,639,128
Available for dividend		1,879,768
Less dividend requirements ($2.75 per share)		2,303,000
Deficit		423,232

It will be noted that earnings fail to meet normal dividends by $423,000.

That the normal dividends of $2,303,000 do not represent excessive earnings is obvious from the fact that cost of plant and necessary working capital is in excess of $40,000,000.

This normal dividend has been regularly paid for more than 10 years past and many stockholders will suffer great hardship if curtailment is forced through excessive corporate taxation.

There are 12,109 stockholders with an average holding of 69 shares each upon which they receive a total of $190 annually in dividends.

The great bulk of these stockholders are in the moderate-income class where Congress has determined that rates of 25 percent or less are equitable. Any reduction of their income caused by tax forced dividend reduction means a tax of 100 percent on that portion of their income instead of at the rate fixed by Congress as equitable.

Compare the situation with that outlined by Mr. Morgenthau when he recommended:

"* * * At a time like this, I am confident that incorporated business will willingly pay additional taxes which will, after all, leave it in the aggregate about the same amount of income after taxes as during the years before 1940."

The above undesired result would seem to be caused by the failure of the House committee to recognize the need for special treatment of corporations with slow capital turn-over. Certain possible remedies are outlined in section V. These should receive careful consideration.

I believe that Congress is interested in preserving the health and morale of the Nation. This is sure to suffer if dividend rates of long standing and by which, in part, the individuals' standard of living has been governed are forced down by excessive corporate taxation superimposed upon his individual taxation.

The legal fiction of the corporation as an entity does not suffer but rather it is the individual investor on whom Congress has supposedly placed such rate of taxation in accordance with his total amount of income as has been determined to be equitable.

It is not claimed in the case of this company that new capital cannot be attained (see sec. I) even with the proposed taxation since there is, at the present time, sufficient equity capital to support considerable additional senior securities. It must be remembered however that this company is practically unique in the industry with respect to its freedom from any material amount of debt.

SECTION IV. PROPOSED POST-WAR REFUND

The proposal that the corporate taxpayer be given special bonds to the extent of some part of its excess-profits tax as was at one time approved by the House Ways and Means Committee will not, if subject to restrictions as to use, be of any help as to earnings. In the form previously approved it was not a reduction of tax which thereby increased the distributable earnings but was only a contribution to capital.

The conversion into cash will furnish funds for a later plant rehabilition or extension but unless completely free from conditions or restrictions cannot ever appear as earned surplus. The bond (or later as its cash or property equivalent) will appear on the books as an asset but there will be a balancing item on the liability side of a "contribution." Inasmuch as the Federal Government is usually a customer through service to the post office, the item is covered in the prescribed utility accounting under the caption of "Customer contributions to capital."

In the case of a public utility, the plant built from the proceeds of these bonds will not even have future earning power as any regulatory commission would deduct this Federal contribution from the cost of the plant in determining a rate base.

The proposal must, therefore, not be considered in any way to relieve a utility from the proposed tax burden.

SECTION V. SUGGESTED REMEDIES

1. To return normal and excess profits to their proper and logical sequence. The equity of an excess-profits tax lies in ability to pay—and ability to pay cannot be evaluated except by a consideration of such earnings as belong to the stockholders after all obligations for expenses and other taxes have been met.

2. To treat as an expense in 1942 and subsequent tax returns such sinking fund payments as are made in accordance with the terms of the bonds outstanding as of July 1942; but not so to treat such payments in reviewing the earnings of the base years 1936, 1937, 1938, 1939 when determining the amount of income subject to excess-profits tax; thus equalizing the "invested capital" and the "comparative earning" method in respect to this allowance.

3. Lay a graduated tax on income subject to excess-profits tax. The blocks of the graduation should not be measured by any arbitrary number of dollars as was done in the past but on a number of dollars to be determined as a percentage of the earning credit allowed in the determination of the amount of income subject to this tax. In this way only a moderate assessment would be laid on a slight overrun, but the assessment would approach 100 percent in event of large overruns of the allowable credit—

For example:

First block, 10 percent of base credit earnings at 25 percent.
Next block, (?) percent of base credit earnings at 50 percent.
Next block, (?) percent of base credit earnings at 75 percent.
All excess at 100 percent.

The reason that blocking the tax has fallen down in the past is due to the blocking being done by absolute dollars rather than by percentage over normal earnings.

4. In any determination of invested capital to recognize as invested capital all money spent for plant regardless of whether financed by money provided by stock issues, bond issues, or from surplus earnings. Under the present law only 50 percent of bond money is recognized. This is probably with the thought that bond money is cheap money. This, however, is not the case as in contrast to equity money the principle must be repaid. Interest and sinking fund payments together amount to about 6 percent which is comparable to an equity return.

5. Recognize the need for added earnings in cases of plant expansion whether financed by stock or bond when using the comparative basis for determining income subject to excess-profits tax. The Hartford Electric Light Co. needs more earnings than that of the base years wherewith to pay interest and sinking fund on $7,000,000, put into plant expansion to care for war industries, which amount was financed by bonds.

The above methods of relief apply to all varieties of corporations. It will probably be desirable to recognize the slowness of turn-over by a specific consideration. The following will not benefit war industries in the slightest as their annual sales in all cases exceed "invested capital."

6. To reduce the excess-profits tax as otherwise determined according to the ratio of annual sales to invested capital, as defined elsewhere, in all cases where this ratio is less than unity.

The CHAIRMAN. The committee will recess until Monday at 10 o'clock.

(Whereupon, at the hour of 1:10 p. m., a recess was taken until 10 a. m., Monday, August 3, 1942.)

REVENUE ACT OF 1942

MONDAY, AUGUST 3, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order. Senator John Thomas of Idaho is submitting a brief in opposition to the 5-percent freight tax in the tax bill now before us, and asks that it be inserted in the record. If there is no objection, Senator Thomas' brief will be included in the record.

(The brief referred to is as follows:)

BRIEF SUBMITTED BY SENATOR JOHN THOMAS OF IDAHO IN OPPOSITION TO PROPOSED TAX ON FREIGHT TRAFFIC

I desire to make a protest on behalf of agricultural and business organizations and citizens of the State of Idaho against the proposed tax on freight and express traffic in the revenue bill as passed by the House of Representatives.

The tax would be grossly discriminatory against the farm, forest, and mineral products of my State and would give an advantage to competing products from States located closer to the central markets.

The effect of the 5-percent tax on freight and express charges would be to add very greatly to the cost of shipment of Idaho products to the markets while increasing by a much smaller amount the cost of shipments from less distant points.

Obviously, there can be no justification for a tax which tends to injure producers in one geographical area and simultaneously places competitors in another area in a relatively more favorable position.

Idaho producers have no desire to avoid their fair share of taxation. They have good reason to protest, however, when a tax is so manifestly unfair.

Specific examples of the effect of the proposed tax are given in letters from various organizations and individuals which I offer for the record of the committee's hearings.

Idaho has a higher average freight rate than any other State on perishable commodities shipped to the leading markets of the country. The average freight rate on Idaho potatoes, for example, is 75 cents per hundred pounds, as against an average on Maine potatoes of 50 cents and on Wisconsin potatoes of 25 cents. The 5-percent tax would bear 200 percent more heavily on Idaho potatoes than on Wisconsin potatoes and 50 percent more heavily on Idaho potatoes than on Maine potatoes.

The tax on livestock shipped from Idaho to the Chicago market would be 10 times as great as on animals shipped from Illinois, Wisconsin, and Michigan. Grain growers in Idaho would pay a tax 3 times as great as would be applied to grain shipped to Chicago from Kansas. On lumber shipped from Idaho to Chicago the tax would be twice as great as on competing Southern pine from Mississippi.

If a tax on freight and express traffic is to be imposed it would be less discriminatory if the basis were changed in such a way as to eliminate the

element of distance. Thus the House Ways and Means Committee amended the original proposal by changing the tax on coal from a percentage to a tonnage basis. I realize, however, that a uniform tax based on weight or volume of freight probably would yield a much smaller amount of revenue than a tax on the cost of shipments. A very large volume of traffic at present is for the account of the Government and would be exempt from the tax.

Instead of trying to modify the proposal, the committee should, I believe, eliminate it entirely. Such action would be in accord with the recommending of the Secretary of the Treasury who in his appearance before this committee asserted that the tax would directly threaten the stability of prices. The Price Administrator has taken a similar position. There can be no question but that a percentage tax on all freight and express charges would contribute very greatly to an inflationary increase in costs of living. It is a tax whose injurious effects would far outweigh any advantage to the Treasury.

I also desire to have incorporated in the record of the hearings a letter from Mr. H. W. Morrison, president of the Morrison-Knudson Co., of Boise, Idaho, with respect to administrative difficulties of employers, especially contractors, in connection with the proposed deduction of income taxes at the source. Mr. Morrison does not oppose such a deduction but suggests a simplified procedure which would be less burdensome to large employers whose turn-over of labor is very great. Mr. Morrison's firm is doing construction work on a number of important Government projects in the West.

IDAHO FARM BUREAU FEDERATION,
Pocatello, Idaho, July 22, 1942.

Senator JOHN THOMAS,
Washington, D. C.

DEAR SENATOR: The people of Idaho and other Western and Southern States, situated long distances from their markets, will be required to pay several times the amount of tax required of people in States close to their markets, if a tax measure now before Congress becomes law. The measure would, I am informed, impose a 5-percent tax on freight rates.

The tax required of Idaho sheep and hog growers, under this measure, would be approximately 10 times as much as that required of sheep and hog growers from Illinois, eastern Michigan, and Wisconsin.

The freight rate on sheep and hogs, double deck, from central Idaho to Chicago is $1.08 per hundred pounds, as compared with 10 cents from Illinois, eastern Michigan, and Wisconsin. Therefore 5-percent tax on Idaho rate, would amount to 5 cents, as compared with one-half cent on the rate of Illinois, eastern Michigan, and Wisconsin.

Idaho potato growers would have to pay approximately 3½ times as much as potato growers in Wisconsin, on shipments to Chicago. Grain growers in Idaho would have to pay approximately three times as much tax, as Kansas grain growers, on shipments to Chicago. A similar inequality would exist as to merchandise and manufactured articles of all kinds, shipped from the manufacturing centers.

I am in favor of any necessary tax for war, so long as it is equitable and is not prejudicial to the people of Idaho, or of other States. I feel that you should do all in your power to defeat this measure.

Very truly yours,

ALFRED C. CORDON,
Legal Advisor, Idaho Farm Bureau Federation.

IDAHO TRAFFIC ASSOCIATION, INC.,
Idaho Falls, Idaho, July 22, 1942.

Hon. JOHN THOMAS, *Member of of Congress,*
Hon. D. WORTH CLARK, *Member of Congress,*
Washington, D. C.

DEAR SENATORS: In re the 5-percent tax on freight bills will say that we note this matter is now before the United States Senate for consideration. This tax is so manifestly unfair and unworkable that we sincerely hope that you will be able to succeed in having the same either eliminated or changed to a flat tax

of so much per ton on all commodities shipped or sold, whether the same moves by rail, common-carrier truck, or by private truck.

Owing to the fact that Idaho has the highest average freight rate on perishable commodities this tax would be unjust and unreasonable. As an illustration: Our average freight on potatoes is 75 cents per hundredweight, while the average out of Maine would be 50 cents per hundredweight, and out of Wisconsin about 25 cents per hundredweight, so you can readily see how much more taxes the producer in Idaho would be called upon to pay than would the producer in either Maine or Wisconsin. This also applies to livestock and all other commodities that are produced and shipped from the State. Also, owing to the fact that Idaho has a very limited population and home consumption, practically everything we produce must be shipped. This is not true in a great many States, such as Pennsylvania, Ohio, Indiana, Michigan, New York, and others, where a lot of the commodities move direct from the farm to the market via the farmer's own truck, on which there would be no tax.

Besides being unjust and unreasonable, the tax would be unworkable, for the reason that the final destination and the total amount of the tax on each freight bill would not be known at the time the commodity was shipped. As an example: I might sell a car of potatoes to a receiver in Chicago and, so far as I am concerned, it would be a complete sale; however, this car would not necessarily be unloaded in Chicago, but might be sold by the Chicago receiver and diverted into New York City where there would be an additional freight charge and an additional tax and it would be impossible for anyone to know how many revenue stamps, or the amount of taxes, which should be paid on any car at the time it was loaded.

This is also true in regard to livestock, particularly lambs from Idaho, which may be first offered for sale at Ogden or Denver and sold, as far as the Idaho producer is concerned, and that would end his freight bill. However, the same lambs might move to Omaha, Chicago, or even to Buffalo, N. Y., before they were slaughtered, and, under the present proposed law, someone would have to pay additional taxes.

It appears to us that the sensible tax would be a very nominal charge per ton on all commodities. They have made a reasonable charge of 5 cents per ton on coal and surely 10 cents per ton on all other commodities, particularly perishables, would be a sufficient tax to meet the present situation. With such a tax every shipper or every producer would know what to do at the time he sold his commodities.

Hoping that you may be able to get the law changed in this matter, I beg to remain,

Yours very truly,

C. L. DELONG, *Counsel.*

STATE OF IDAHO,
PUBLIC UTILITIES COMMISSION,
Boise, Idaho, July 17, 1942.

CHAS. E. BLAINE,
Traffic Counsel, American National Live Stock Association,
Phoenix, Ariz.

FRED MARSHALL,
Secretary, National Woolgrowers Association,
Salt Lake City, Utah.

F. R. MOLLIN,
Secretary, American National Live Stock Association,
Denver, Colo.

E. T. TAYLOR,
Master, Idaho State Grange,
Coeur d'Alene, Idaho.

ALFRED CORDON,
Legal Adviser, Idaho Farm Bureau Federation,
Pocatello, Idaho.

GENTLEMEN: Congress proposes to enact into law a 5-percent tax on freight rates. I have information that the Ways and Means Committee of the House of Representatives has approved the measure with the exception that coal would be taxed 5 cents per ton instead of 5 percent.

In my opinion this measure is inequitable and is prejudicial to the farmers of the West and the South. It will create a condition whereby people located long distances from their markets will pay the bulk of the amount which the Government will collect on this tax. As an example, our rate on sheep and hogs, double deck, from central Idaho to Chicago, the packing center of the Nation, is $1 08 per hundred pounds. Our tax would be 5 cents per hundred. A farmer shipping livestock in Illinois or eastern Wisconsin and Michigan to Chicago might have a rate of 10 cents per hundred pounds and under this measure would pay one-half cent per hundred pounds tax. The processor of livestock will not absorb this tax. It will be charged to the producer and will probably be paid by the packing company who, in turn, will deduct the tax from the return which they make to the livestock producer.

Every product of agriculture and of the range will be affected in the same manner and it is my belief that the farm organizations of the Nation should immediately ask the Congress to defeat this measure. It is my information that the measure will reach the floor of the House of Representatives under the so-called closed rule, which means that there will be no debate. Hence, it is important that Members of Congress be made aware of the burden which will be imposed on the West and the South if this measure prevails. Idaho is not opposed to any tax for the war effort in which we will bear an equal burden with the residents of other States.

This commission is hopeful that the great national associations representing the farmers of this Nation will do something to defeat this measure.

Very truly yours,

PUBLIC UTILITIES COMMISSION OF IDAHO,
J. G. BRUCE, *Chief of Transportation.*

cc. State commissions, South and West.

[Telegram]

BOISE, IDAHO, *July 15, 1942.*

Senator JOHN THOMAS,
Senate Office Building, Washington, D. C.:

Please advise if we can assist in any way in opposing proposed 5 percent freight tax which penalizes our long-haul shippers in competition with those areas close to consuming centers. Practically every phase of our agricultural and commercial life is adversely affected.

IDAHO STATE CHAMBER OF COMMERCE.

BOISE CHAMBER OF COMMERCE,
Boise, Idaho, July 14, 1942.

The Honorable JOHN THOMAS,
United States Senator,
Senate Building, Washington, D. C.

DEAR SENATOR THOMAS: We know you fully realize how unfairly any 5 percent or 10 percent tax on freight would affect us in Idaho, as we hear the House Ways and Means Committee has included in its 1943 revenue bill.

If it is necessary in the war program to tax freight shipments to raise money, why not add 50 cents or $1, or whatever the amount, to each freight shipment and make this charge uniform throughout the country?

We hope you will watch this item in the tax bill as we read that no amendments will be made from the floor of the House when the bill is reported there.

Sincerely,

BOISE CHAMBER OF COMMERCE,
E. G. HARLAN, *Manager.*

[Telegram]

PAYETTE, IDAHO, *July 15, 1942.*

Senator JOHN THOMAS,
Washington, D. C.:

Informed that revenue bill provides 5 percent freight charges. Would be severe penalty on account our high freight rates to eastern markets. Also our high

incoming freight rates on supplies. We wish enter our protest against said bill on agricultural products and on supplies used in agriculture.

F. H. HOGUE,
J C PALUMBO,
FRANK B. ARATA.

POTLATCH FORESTS, INC.,
Lewiston, Idaho, July 7, 1942.

Hon. JOHN THOMAS,
United States Senate, Washington, D. C.

DEAR SENATOR: I know that you will believe I am reluctant to write you on a controversial tax measure at a time like this and yet I feel it my duty to do so.

The proposal to raise revenue by a flat percentage tax on freight charges would be, if enacted in law, a most inequitable measure. The lumber industry of Idaho and the west generally now labors under a very considerable freight charge handicap as compared to the south particularly and to the less important lumber-producing regions in the east and north. A percentage increase on freight charges would obviously increase this differential and we believe the needed revenue should be raised in some other way.

I do not mean that freight charges should be eliminated as a taxable source of additional revenue but believe that, even in this field, there must surely be a more equitable manner of framing or assessing a freight charge tax. One such method might be to impose a flat tax per ton on all freight shipments. A second method might be to have a graded tax per ton on a few rough classifications such as coal, ore, grain, building materials, food products, and other manufactured products.

I hope you can find time to give this matter some thought and that if you agree with me, you will be able to present your views. Surely some method of applying a freight charge tax can be devised which will not disrupt competitive conditions inside an industry.

Very truly yours,

POTLATCH FORESTS, INC.,
C. L. BILLINGS,
Vice President.

CRAIG MOUNTAIN LUMBER CO.,
Winchester, Idaho, July 7, 1942.

Subject: Effect of 5 percent transportation tax on our rate structure.

Senator JOHN THOMAS,
Washington, D. C.

MY DEAR MR. THOMAS: The House Ways and Means Committee last week completed its work on the new revenue bill and turned its recommendations over to drafting experts for whipping into final shape so the bill may be presented to Congress. We understand the bill will be presented on the House floor next week.

The tentative draft of the bill, as approved by the House committee, places a 5-percent tax on all freight and express shipments moving by any type of common or contract carrier. It also increases the tax on passenger transportation from 5 to 10 percent.

The proposed tax will increase the spread in lumber rates by 2 or more cents over southern pine. For example:

	To Chicago		
	June 24, 1918	Present	Proposed 5 percent tax
From west coast	55	80	84
From Hattiesburg, Miss.	26½	42	44
Spread in rates	28½	38	40

Chicago is typical of the general situation and serves to illustrate the difficulty west coast lumbermen experience in marketing their products in long-haul competitive territory.

It is obvious to everyone that a percentage tax levied upon freight charges has exactly the same effect upon our rate structure as a percentage increase in freight rates. We stood a 6-percent rate increase during March this year (I. C. C. exparte 123). Piling up these percentage increases in transportation charges will greatly handicap our long-haul traffic and act to the benefit of the short-haul traffic. Southern pine will benefit from this tax particularly after the Government withdraws from the lumber market. The point which should be kept in mind is that in the highly competitive market of the post-war period every item which increases our delivered price will be handicap.

Lumber alone is not the only commodity affected, but all long-haul traffic including farm products.

We request that you give this bill thorough study and oppose its passage. Please advise your reactions as it is serious.

Yours very truly,

CRAIG MOUNTAIN LUMBER CO.,
W. C. GEDDES, *President.*

MORRISON-KNUDSON CO., INC.,
BOISE, IDAHO, *July 23, 1942.*

Re: Pending tax bill.

Hon. JOHN THOMAS,
Washington, D. C.

DEAR SENATOR THOMAS: The current revenue bill which was recently approved by the House and which is now under consideration by the Senate Finance Committee, contains a provision requiring pay-roll deductions. We understand this to provide for the deduction of certain sums from earnings of employees and the deduction is to be made by the employer and remitted to the Government. Under the proposed plan as contemplated, we understand that the employer is made responsible for determining the status of dependency of each of his employees and is required to make the proposed deduction under a very complicated formula.

We believe that those originating this proposed method for making these deductions, have failed to give consideration to the tremendous problems involved in the handling of same insofar as the construction industry is concerned. It must be understood that the number of employees on pay rolls of operators such as ourselves, vary several thousand in a single month. Some of the defense projects we are handling are presumed to be started and completed in as little as 45 days' time. Such projects may involve the recruiting and employing of two to three thousand men. Others employ up to 10,000 men over a period of 4 to 5 months. Obviously, this proposed method of making these deductions would require such a tremendous accounting organization as to make the cost unduly burdensome to the employer.

We request your consideration of this matter in an effort to provide that such deductions as are made, should be made on a flat percentage basis of the employee's income, and if the employee has been overcharged through these deductions, same should be refunded by the Treasury Department or subsequent credits allowed.

We are not opposing the principle of pay-roll deductions for tax purposes, but do believe in the interests of reasonable efficiency that consideration of the method for accomplishing this objective as it applies to the construction business, should be given consideration.

Yours sincerely,

H. W. MORRISON,
President and General Manager.

Senator DAVIS. Somebody made a statement here as to the amount of joint tax returns. How much did they say it would bring in revenue to the Government?

The CHAIRMAN. The Treasury estimated $420,000,000. Community property is only $85,000,000. That is the Treasury estimate.

Governor Hobby. Governor Hobby is scheduled here as the first witness this morning. He does not seem to be present.

Mr. Tobin.

STATEMENT OF AUSTIN J. TOBIN, NEW YORK, N. Y., SECRETARY, CONFERENCE ON STATE DEFENSE

The CHAIRMAN. Before you proceed, Mr. Tobin, we have a long list of witnesses here on State and municipal bonds. Is it desired to have them all appear and make statements?

Mr. TOBIN. Well, Senator, since the issue of future issues is to be considered by the committee, we had outlined a rather brief presentation of about five witnesses and then the United States Conference of Mayors and the American Municipal Association felt that they wanted to be personally represented here, Mayor Jeffries, of Detroit and Mayor LaGuardia, of New York, decided they wished to come on behalf of those organizations.

The CHAIRMAN. Of curse, we will be glad to hear from all witnesses that desire really to present anything on the tax bill. This is not a wholly new subject to this committee, and, of course, it is not new to anyone in the country. We have not put any time limitation yet on witnesses, but it is going to become necessary this week, in view of the unusual number of requests that are now coming in to the committee, to put such a time limitation on.

We will ask you to be as brief as you can, in handling this particular subject.

Mr. TOBIN. We have tried to do that, Senator.

We are quite aware of the fact that this matter has been thoroughly aired before Senator Brown's special committee.

The CHAIRMAN. This committee is more or less familiar with the general proposal. Of course, we desire to hear from you. I do make that suggestion in the interest of time.

It is going to be necessary during the week, I am quite satisfied now, to actually limit witnesses who appear here in order to expedite the hearing.

Mr. TOBIN. Senator, what we had in mind was, I would attempt to place in the record an outline of the points in opposition, which will be very sketchy, but since it is an outline of a very important subject, it will take some time.

Then Professor Lutz and Professor Fairchild will give you their views on the fiscal and economic state, and Mayor Jeffries on its effect on the smaller communities in particular, and then Solicitor General Epstein will sum up the law.

How much he has condensed it may be illustrated by the fact that his summation of the law will take about 7 minutes.

The CHAIRMAN. You may proceed, Mr. Tobin.

Mr. TOBIN. Mr. Chairman and members of the committee, every time this proposal for the Federal taxation of future issues of State and municipal securities has been placed before Congress, you have stood shoulder to shoulder with your local officials in rejecting it.

In 1918 and in 1924 it was beaten on the floor of the House. In 1940 it was beaten on the floor of the Senate. In each of the last 4 years the Ways and Means Committee has refused to report the pro-

posal, after holding extensive hearings in 1939 and in March of this year.

Indeed, Congress has gone further; since 1913 you have insisted upon your own positive recognition of the immunity of local bonds by reenacting the statutory exemption in every revenue act. On the face of this record it is clear that Congress harbors no illusions as to the real meaning of this recommendation, and that you fully appreciate its destructive political consequences.

There are three points in the recommendation of the Secretary of the Treasury for Federal taxation of future issues of State and municipal bonds that I would like to meet immediately:

First, Federal taxation of future issues would produce practically no Federal revenues for the next 10 years, and no substantial revenues for the next 20 to 30 years. This is admitted by the Treasury. It is implicit in Mr. Morgenthau's estimate of a total revenue of only 200 million a year even if all outstanding municipal bonds were taxed now. In 1939 Under Secretary of the Treasury John Hanes described the anticipated revenues from this proposal as "unimportant." How unimportant they would be is indicated by the fact that all the revenues that might be anticipated from the taxation of future issues of State and municipal bonds during the first 6 months of this year would be sufficient only to finance the war for about 30 minutes.

On the other hand, cities with urgent refunding programs, such as Detroit and Philadelphia, would feel the impact of a tax on future issues immediately, and cities which are loyally cooperating in the war effort to provide the roads, the sewers, the water supply, and the schools required immediately by expanding war industries, such as Norfolk, San Diego, Wichita, and Cleveland, would feel the heavy burden of increased borrowing costs at once.

Second, the so-called evil of the exempt security has been grossly exaggerated. The overwhelming majority of our State and municipal bonds are to be found in public trust funds, sinking funds, bank reserves, insurance companies, and other depositaries which are not affected by high personal surtaxes.

Only a relatively small proportion of State and municipal securities are in the hands of persons of wealth. Studies of the Treasury's own estate tax records throughout the period 1926 to 1939, inclusive, show that only 6 percent of the capital in all estates over $50,000 has been invested in State and local bonds. And the Treasury's estate tax figures for 1940 show a further and sharp decline in the holdings of these securities in large estates.

Indeed, one of the Treasury's own witnesses before the special Senate committee, Prof. Kossuth M. Williamson, has recently written that "the extent of evasion by the rich, through tax exemption, has been exaggerated * * *."

In all events, the evil consequences of this proposal so far outweigh the controversial issues as to how large a loophole may be involved that, as has frequently been said, it amounts to a recommendation for the burning down of the barn to catch a few mice.

Third, this is not a bondholder's fight. You have already rejected the recommendation to tax outstanding local issues. We fight rather to protect the fiscal independence of the American State and the American city for the future.

The 9,000 cities represented in the American Municipal Association are opposed to this proposal. The United States Conference of Mayors has expressed its "unanimous and implacable opposition."

State leagues of municipalities throughout the country are unanimous in their opposition. The Municipal Finance Officers Association, composed of local officials who have the duty and responsibility of the sound administration of the fiscal affairs of the municipalities, have repeatedly condemned its destructive consequences. They are joined in their opposition here today by the American Federation of Labor, the National Education Association, and the American Bar Association.

As Senators Warren Austin and Edward R. Burke said in 1940:

> We have not here the partisan testimony of persons interested in pecuniary gain for themselves, or in the accomplishment of some ulterior objective. These witnesses were public officials charged with the duty of protecting the interests of their communities. They had no personal axe to grind. Anyone who sat through the hearings must have been impressed with their sincerity and their conviction that it would jeopardize the financial welfare of their communities and that it was their duty to oppose it.

We submit that much of the misunderstanding of this proposal arises because the Treasury discusses it simply as a problem in taxation or in alleged tax evasion. But this is not a problem in abstract economics. The answer is not to be found by adding up possible Federal tax revenues on the one hand, increased interest costs to local government on the other, and then subtracting the two totals. The real nature of this problem is one of the preservation of independent local government, of the continuance of true federalism under our constitution. It is a problem that reaches into the very nature and quality of the democratic process itself. As Senator Bailey has well said:

> The really great issue here is not one of revenue. The really great issue here is the power of one sovereignty to tax another, and the wisdom of it, even conceding that the Federal Government has the right to tax the credit of my State, for that is what it all amounts to.

We do not think there is any competent authority who does not admit this proposal would substantially increase the cost of local financing. And there would seem to be general agreement that that increase would probably be about 1 percent in the interest rate, or an increase in State and local borrowing costs of 33 percent on a 3 percent municipal bond.

Thus, Professor Lutz and Professor Fairchild who will discuss this consequence of the proposal in greater detail, both agree upon the prediction of an increase of about 1 percent.

The Reconstruction Finance Corporation has indicated an estimated increase of three-fourths of 1 percent, the Comptroller of the city of New York has foreseen the increase at 1¼ percent in the rate on New York City bonds, and the late Morris Tremaine, comptroller of the State of New York, estimated the increase at three-fourths of 1 percent.

The committee may recall the collapse of the municipal market on January 26 last, immediately following Mr. Morgenthau's Cleveland speech on this issue. And the charts and tables submitted by the Secretary of the Treasury to the House Ways and Means Committee (pp. 75 and 76 of the Hearings on Revenue Revision of 1942) indicate

an average differential for the year 1941 of 86 basis points between high-grade corporate securities and high-grade municipals.

This is very close to the differential of nine-tenths of 1 percent predicted by Dr. Lutz and the differential of 1 percent in the interest rate predicted by Dr. Fairchild. According to the same figures of the Secretary of the Treasury, high-grade municipals have been selling for the past year below a 2-percent basis. Hence an increase of even eight-tenths of 1 percent on a 2-percent security would represent an increase of 40 percent in the cost of new municipal financing over what the cities have been able to do on the present basis,

Such differentials in cost would indicate that the states and cities might ultimately face an annual increase of $175,000,000 in their borrowing costs as a result of this proposal. And this at a time when the States are faced with an annual loss of over $500,000,000 a year in motor vehicle taxes and revenues.

But the consequences are even more alarming. In many cases and in many times, a Federal tax on municipal bonds would make it impossible for the local governments to exercise their borrowing powers at all, and would mark the dividing line between success and failure in the financing and refunding operations of thousands of communities. This is emphasized in the telegraphic appeal which Mayor Voller, of Springfield, Ohio, has just sent to Senator Taft:

> Permit me as mayor of one small city and on behalf of the millions of small local taxpayers throughout the Nation to implore you to vote against taxing future municipal bond issues. Your Finance Committee is to be commended for its vote against taxation of outstanding municipal issues. While we are mindful of the dire Federal need we are also impressed with the fact that as between the equity of taxing income in the hands of the limited few holders of municipals, the greater equity lies with the millions of local taxpayers who would have their already high taxes increased to pay the higher rate of interest on their municipal bonds. In my opinion a Federal tax on municipal bonds will pretty nearly wreck the finances of many American cities, including Springfield, Ohio.

Many of our local obligations for schools, hospitals, water supplies, sewers, roads, and other purposes have been issued at, or close to, the maximum rate at which they could be sold and at which the local community could reasonably support its debt service. Thus, as the representative of the Municipal Finance Officers Association, Mr. Chatters, will demonstrate to you, during the 7 years 1919–22 and 1932–34, $1,219,000,000 of State and municipal bonds were sold at interest rates of 5¾ percent or higher.

It is one thing for a municipality to promise to pay a higher interest rate as the direct result of a Federal tax on its bonds; it is another thing to be able to pay it. If, in the judgment of the money market, a State or city cannot meet that rate over the life of the security, its power to carry on local government has been effectively destroyed. And, in many cases, the increased interest rate will exceed the limitations placed upon local government by State constitutions. In the recent words of the Supreme Court, the doctrine of immunity—

> recognizes the direct effect of a tax which would operate on the power to borrow before it is exercised and which would directly affect the Government's obligation as a continuing security.

Nor is this partial paralysis of the power of local government to finance itself, and so to carry on its functions, confined to the smaller or to the weaker units of local government. Mayor LaGuardia told

the House Committee in 1939 that if the bonds of the City of New York were subject to the Federal taxing powers it would have been impossible for the city of New York to take over its transit systems or to have gone forward with other vitally needed metropolitan improvements.

If the functioning of local government is vital to our liberties in times of peace, it is vital to our national existence in times of war. And this is particularly true in a war that is being fought in and by the cities themselves.

When, therefore, the advocates of this attack on local financing come forward with the plea that the war effort requires this tax and refer to a "pre-Pearl Harbor exemption" we think that it demonstrates a cynical opportunism which is not usually the hallmark of a good cause. It is just as much the fact now as it was before Pearl Harbor that a Federal tax on future issues of local securities would produce no substantial revenues for the next 10 or 20 years. And for the same reason taxation of future issues could have no bearing on the alleged aggravation of tax evasion by reason of mounting tax rates.

National defense calls for the fullest cooperation of States and municipalities in the maintenance and construction of municipal services and facilities vital to the war effort. It requires the strengthening of their credit standing and the utmost efficiency in the administration of their local affairs. The cities are loyally meeting these proper demands enlisting local government "for the duration." Nothing would prove of greater injury to this unity of purpose and effort than for the Federal Government to attempt to tax municipal securities, to increase our local interest costs and to move, at this time, toward the disestablishment of that federalism which is the real strength of these 48 United States.

The power to tax always carries with it the power to exempt and to classify the subjects of taxation. Thus, any future administration controlling the Federal Government could, through the power to tax our securities, and through the power to exempt and to classify within the activities of local government, control every operation of the States and cities.

An example of this is at hand today. While one department seeks to establish a Federal power to tax State and municipal bonds, another is insisting upon the complete exemption of local housing bonds from all present and future Federal taxes. Thus, if complete Federal power to tax the operations of local government is once established, the entire social and economic program of the States and cities can be similarly controlled and directed.

Very recently the Governor of the Federal Reserve System said that we must look upon the power of taxation not simply from the aspect of raising revenue but as an instrument for the attainment of social and economic objectives. If that is the objective of the Federal power of taxation in these changing times, then the immunity of our State governments from what the Department of Justice calls the supreme taxing power of the Federal Government is a more urgent battle for the preservation of our Federal system than it has ever been before.

For then the Federal power to tax is clearly the power to impose the social and economic objectives of the central Government upon

every State and city in the country; then every concept of a Federal system under our present Constitution is wiped out; and we have an omnipotent national state.

The other day the High Court of Australia practically wiped out the fiscal power of the Australian States. As reported in the New York Times of July 26, former Prime Minister Menzies commented that the decision—

> marked the end of the Federal era in the constitutional relations of commonwealth states and the beginning of a new era in which the Government of Australia must be regarded as much more a unitary government and much less a Federal system than it was previously thought to be.

And the Times report noted that—

> The Unificationists consequently welcome the judgment as a first step toward great constitutional changes that will rapidly reduce the States to a subordinate position resembling that of the Provinces of South Africa.

When our own Treasury Department refers, as it does, to the "supreme taxing power of the Federal Government" I presume it has the same objectives in mind.

Last week, before this committee, the Treasury's representative agreed with Senator Clark that in order to test the constitutionality of the Treasury proposal, it would be necessary to insert a provision in the current revenue bill taxing these bonds. Yet, in March 1941, the Treasury commenced test actions against bondholders of the Port of New York Authority and the Triborough Bridge Authority.

These test cases are now pending trial in the Board of Tax Appeals. The Treasury's press release, issued when these actions were commenced, stated that they were "intended ultimately to prove in the courts that the Federal Government has the right" under the Constitution to tax the income from all State and municipal securities. In effect, the Treasury now asks the Congress to take a definite position on a highly controversial constitutional question which the Treasury itself has started on its way to the Supreme Court.

When the Court decides the pending cases Congress will have a direct and firm ruling on the constitutional question raised by the proposed statute. It would seem to be the prudent and orderly course to await that decision. Indeed, it would seem to be the course which the Treasury itself set in initiating those cases.

The destructive character of the claims for the legality of this proposal is indicated by the language which the Treasury and Department of Justice have used in outlining their new conceptions of the supremacy of the Federal taxing power with respect to the functions of local government. They urge that while the Federal Government may not be taxed by the States the States are in the future to be completely subject to the taxing power of the Federal Government. Thus, in the study submitted to the Special Senate Committee in 1939, the Department suggested—

> that the principle of immunity protected the Federal Government against taxation by the States, but did not necessarily shield the States from the exercise of the delegated and supreme taxing power of the Central Government.

And the Chief Counsel of the Bureau of Internal Revenue in further developing this destructive thesis, has argued flatly that the National

Government has power to tax the institutions of the State. These sweeping assertions of power are inherent in and inseparable from the proposal at issue here.

It would be one thing if the gun which the Treasury seeks to put in your hands was gaged to hit only the bondholder, but what they press upon you here shoots canister and grape into our whole political system.

When we appeared before the special Senate committee in 1939, the Treasury assured that committee that it had absolutely no intention of taxing outstanding issues.

On the basis of those assurances, Senator Brown deprecated our predictions at that time that outstanding bonds would be next on the list, saying that—

while we may be a pretty bad outfit, and not stand by our word, I am inclined to think the temptation in this case is not very great.

Yet, the Treasury has, as we predicted, already moved on to this objective. And on the basis of the same supreme power to tax the States which is here asserted, they have gone on to proclaim Federal power to tax not only the price we pay for our municipal borrowing, but the principal of the bonds themselves, the pay rolls of the States and cities, and, indeed the very revenues of State agencies. As the report submitted to you in 1940 by Senators Austin and Burke said:

It is difficult to believe that those who support this measure really appreciate the shocking political consequences of the method by which it is proposed to tax these securities.

The Supreme Court has never deviated from, or even questioned, the constitutional premise that the taxing power of the Federal Government does not extend to the income from State and municipal bonds. This was conceded by the Department of Justice when this issue was before the special Senate committee in 1939. They argued rather that the Court has always been in error and that it would shortly reverse itself. There has been no evidence since that the Court would do so. On the contrary, the attorneys general of the States are still in accord with the views submitted to the special Senate committee in 1939 by the staff of your Joint Committee on Internal Revenue Taxation that—

it cannot be established that subsequent decisions have weakened the holding of the *Pollock case* that the Federal Government has no power to tax the income from State or local bonds.

Senator CONNALLY. Let me ask you there, if you will permit a question.

Mr. TOBIN. It is perfectly all right.

Senator CONNALLY. You recognize, do you not, that even in the case of State bonds there must be a governmental function?

Is not there a line of demarkation there as to what is strictly a governmental function?

Mr. TOBIN. That line has been drawn in the *South Carolina case* and in succeeding cases.

Senator CONNALLY. Take North Dakota for instance. They engage in all sorts of State socialistic plans. It is their business, if they want to do that. They have State grain elevators, warehouses, and

all that. Would you extend this doctrine that far, or would you limit it strictly to governmental functions like schools, jails, and roads?

Mr. TOBIN. When you get to the question of issuing bonds for this purpose, where those bonds are issued by the States themselves, I think that that is one of the primary functions of the State government.

Senator CONNALLY. I am with you on your general proposition. I do not want to be maneuvered into a ridiculous position in saying the Federal Government could not tax a bond issue by the States when it was not issued for such purposes.

Mr. TOBIN. They have certainly gone a long way with you in making that proprietary distinction all along the road through salaries, and even excise taxes, and other functions, where they held that the tax did not affect the State in the execution of a primary purpose. They have so held, yet on the question of issuing bonds, I think the question of issuing bonds, where the State is exercising its primary fiscal power in borrowing, is still doubtful. I think you may well argue that the Court will follow this proprietary line there.

Senator CONNALLY. Of course, you are weakening your defense. It would be your original position that they just cannot touch the State law itself.

Mr. TOBIN. You let the Supreme Court decide that question.

Senator CONNALLY. There are several questions about my consent.

Mr. TOBIN. Nevertheless, Senator, it is the only Supreme Court we have.

The CHAIRMAN. All right, Mr. Tobin.

Mr. TOBIN. That was also the conclusion of the report submitted to the Senate in 1940 by two of its outstanding experts in constitutional law, and it was apparently the conclusion which the Senate came to itself in defeating this proposal, after 3 days of debate, on September 19, 1940.

That is 3 days of debate. More recently, that was the unanimous view of the American Bar Association which, on March 17, 1941, took the position that only by constitutional amendment could the Federal Government validly exercise the power which the Treasury here asserts. And the American Bar Association considers the method which is here recommended so serious a threat to our constitutional system that they have asked me to insert here in the record the memorandum which the Honorable Murray Seasongood, of Cincinnati, submitted last March to the Ways and Means Committee on behalf of the bar association.

The Treasury has professed to see great portents for the reversal of the established doctrine of immunity in the so-called independent contractor cases, *James* v. *Dravo Contracting Co.* (302 U. S. 134), and *Alabama* v. *King & Boozer* (86 L. Ed. Adv. Ops. 1 (decided Nov. 10, 1941)).

But in the *Dravo case*, which is twice referred to with evident approval in the Alabama decision, the Court went out of its way to reaffirm the doctrine of the *Pollock case*.

It stated in careful and definite language that these independent contractor cases were clearly distinguishable from the case of State and municipal bond interest, that no logical or legal analogy could

properly be drawn between the two and the immunity of our local bonds from the Federal taxing power was still the law of the land.

The language written by Chief Justice Hughes and concurred in by Justices Stone, Brandeis, Cardozo, and Black could not be more definite.

> There is no ineluctable logic which makes the doctrine of immunity with respect to Government bonds applicable to the earnings of an independent contractor rendering service to the Government. That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised" * * * and which would directly affect the Government's obligations as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit—considerations which are not found in connection with contracts made from time to time for the services of independent contractors.

The real issue here should be very clear. It is an issue that transcends the field of taxation or the field of mere fiscal argument. It rises beyond the niceties of legal debate and distinctions.

If Congress has the power by simple statute to tax State and municipal bonds, it has inevitably the power to control State and municipal financing.

Without control of its own financing no government can continue as a free and independent state. And local government is the entire basis of political democracy.

That is why the States and cities believe that this is the chosen battleground upon which they must make their stand for the preservation of local government and all that it means under our constitutional system.

Under that system democracy itself is completely dependent on the continued freedom of the States to carry on the functions of local government without Federal interference. So long as such a system is to be maintained, tax interference by one government with the functions of the other can only be prevented by reciprocal constitutional immunity.

In the words of the memorandum in opposition which the American Federation of Labor submitted in March to the Ways and Means Committee of the House:

> * * * to preserve the sovereignty to our several and separate State governments, and the home rule of our cities, the credit and borrowing capacity of our several States and political subdivisions should be taxable only by the respective States, thus reserving to the States exclusively this field of taxations, preventing the coercion of the States by the Federal Government and preserving local self-government.

The courageous and able men who gave us the American Constitution had learned the lesson of history. They knew that democracy could only survive in the little governments of the people. Above all things, they dedicated that Constitution to the preservation of these little governments. That is the real issue raised by this Treasury recommendation and this renewal of the attack on State and municipal financing.

The States and cities are confident that this committee will concur in the action of the Ways and Means Committee of the House and that you will once again reject this recommendation.

The CHAIRMAN. Thank you, Mr. Tobin.

(The following statement was submitted by Mr. Tobin:)

STATEMENT OF HENRY F. LONG, COMMISSIONER OF CORPORATIONS AND TAXATION, STATE OF MASSACHUSETTS; ALSO REPRESENTING THE GOVERNORS OF MAINE, NEW HAMPSHIRE, VERMONT, AND MASSACHUSETTS

As the representative of the Governors of Maine, New Hampshire, Vermont, and Massachusetts, I urgently request this committee to oppose the taxation of future issues of municipal bonds. We in New England are solidly against the proposal and feel that its enactment will be of present and permanent disadvantage to us. We believe it is a violation of the accepted relations long continued as between the States and local governments and the Federal Government.

In Massachusetts, as well as in the other New England States, where cities and towns attempt to supply every type of service that can be supplied for the well being of their citizens, high tax rates and a substantial debt have naturally resulted. However, the debt picture is not at all bad, for the policy adopted some years ago has been followed consistently and, as a result, New England's municipal securities have been sold at very attractive rates. These securities are attractive for two reasons:

(1) They are exempt from taxation;

(2) The policies followed make them 100 percent secure and there is no likelihood of any default either on principal or interest.

The past 10 years have been very trying due to unemployment and the resulting increase in the relief load, so that many millions of dollars have been borrowed for the purpose of spreading a portion of this load, particularly for Work Projects Administration projects.

At the present time, there is a suspension of borrowing, for New England in her usual way is looking ahead to the future. We are now chiefly concerned with winning the war and lending every possible aid to the Federal Government by lightening the tax burden wherever possible, by postponing all capital improvements, and by reducing or eliminating entirely many public services which we have come to believe essential for a prosperous and contented community, in order that the taxpayer may be in a better position to subscribe more generously to war bonds and thus help the Federal Government. Massachusetts, as an example of the attitude of the New England States, has enacted special legislation permitting municipalities to appropriate and raise by taxation money to buy Defense bonds to be held until after the close of the war. If the bonds are sold at that time, the proceeds can be used only for such purposes as the city or town could borrow for a period of 10 or more years under the provisions of the general laws. By building up a reserve and reducing our debt at this time, we are preparing the way to enter into an extensive program of public works which will furnish employment to many when they are no longer in military service or employed in defense industry.

Any tax which in any way reduces the attractiveness of New England municipal securities will seriously affect its post-war work, prevent employment, and the rebuilding of neglected municipal properties and service. Those of us in the New England section where our industries are completely engaged in defense work realize that our cities and towns are faced with a problem which affects generations. While we are preparing to meet this problem to the best of our ability, it must be apparent to all that we must be in a position to finance much of the work by pledging the credit of our communities by borrowing. If municipal bonds are taxed, they lose whatever attractiveness they possess, and it would then be harder for a city or town to provide employment at a time when it will be sorely needed. A tax on municipal bonds will not only affect their salability but also add to the cost of the service for which they are issued and is likely to cause a reduction in service, for the loans lose in salable value although it may not mean too much in dollars and cents. We submit as a part of New England's opposition a complete endorsement of the testimony by Austin J. Tobin, Dr. Harley L. Lutz, Prof. Fred Fairchilds, and the others representing the States and cities here today.

The CHAIRMAN. Professor Lutz, come around, please, sir. I have been requested to call the witnesses in the following order:

Professor Lutz, second; Professor Fairchild, third; Mr. Jeffries, fourth; and Mr. Epstein, fifth. I suppose that is agreeable.

All right, Professor.

STATEMENT OF HARLEY L. LUTZ, PROFESSOR OF PUBLIC FINANCE, PRINCETON UNIVERSITY

Mr. LUTZ. Mr. Chairman, and gentlemen of the committee: I think it is very unfortunate that you must take time from the very serious problems of war taxation and war finance that confronts you to deal with a subject which has no bearing on those problems.

I feel that I should apologize for having to be a part of this diversion of your energy.

As you know, for more than 3 years the Treasury has been seeking to extend Federal domination over the States by taxing their bonds. Now, after all other arguments have failed, the red, white, and blue herring of war finance has been dragged across the trail. I am sure this is as unconvincing to you as it is to me. You are aware, as Mr. Tobin has pointed out, that the revenue problem before you is one which requires that the Government provide, by means of additional tax, moneys this year and next year, and you are also aware that the proposal to tax future issues of State and local bonds cannot possibly provide any revenue for the duration of the war, or at least I hope for the duration of the war.

Further, the question of getting revenue by taxing State and local bonds is a process of robbing Peter to pay Paul. In this case Peter is the citizen who must pay the heavier local taxes in order to provide the increased debt service on taxable bonds.

Senator VANDENBERG. Don't you think that rule works both ways? Don't you think Paul ought to ask Peter not to pay so many of his local bills, too?

Mr. LUTZ. I have always been in favor of that, Senator Vandenberg.

Senator CONNALLY. Peter does not have to pay the local bills. We have been doing it. He does not have to pay them unless he wants to.

Mr. LUTZ. You mean the cities and States did not have to come to the Federal Treasury?

Senator CONNALLY. No.

Mr. LUTZ. I will agree to that, but, Senator, if we get into the question of bonds——

Senator CONNALLY. Don't argue with me. I am for you. Don't change my mind.

Mr. LUTZ. No, no; I am not trying to change your mind. We will go on from there. With respect to robbing Peter to pay Paul, there is appended to my statement, which I have handed to the clerk, a chart showing the spread between taxable and exempt Treasury notes.

You remember that a year and a half ago, or a little more, we began the practice of issuing Treasury notes at three-fourths percent interest, and subject to Federal taxes, and we have a very interesting demonstration of the effect of those taxes in the market quotations of the two types of issues, the exempt and taxable issues selling concurrently in the market, and the record of that spread shows that the taxable issues were selling never above the exempt issues, or selling on a yield basis sufficient beyond that, so that the Treasury, in effect, provided the banks with the additional income which they, in turn, paid back

to the Treasury. In other words, the sole effect the issuing of taxable Treasury notes had, the three-fourths percent, was to take some additional money out of the pockets of the general Federal taxpayer and turn it over to the purchasers of these notes, who, in turn, handed it back to the Treasury.

As the New York Times said editorially when this policy was inaugurated, it is perfectly clear that a Treasury note could have been sold at one-half percent exempt from taxes on the same terms in which they sold the three-fourths percent note taxable.

So all we have succeeded in doing, with respect to that particular experiment in taxing Federal securities, is to rob Peter to pay Paul.

We took some money out of the pockets of the general Federal taxpayer and handed it on to the investor who, in turn, paid it back into the Treasury.

Senator RADCLIFFE. Professor Lutz, following out your thought, as you mentioned it a little while ago, would you say that the difference in the interest yield between the taxable and nontaxable is about commensurate to what would be the rate of taxation, or what is the relation between the two? Have you hit upon any basis of a relation between the taxable rate and the difference in yield of the taxable and nontaxable securities?

Mr. LUTZ. You are speaking of the Treasury notes, Senator?

Senator RADCLIFFE. I really did not have any public securites in mind. I was not necessarily taking Treasury notes. Have you worked out a theory on the relative proportion between the two?

Mr. LUTZ. Yes; I was coming to that, if you will permit me.

Senator RADCLIFFE. I am sorry to interrupt you.

Mr. LUTZ. Now continuing with the point I was intending to make when the Senator asked his question, I must point out that all of our discussion and all of our speculation with respect to the effect of the tax is something which requires us to look far ahead. The only way we have of reading this future is by considering the present, and in attempting to approach the present specifically in that connection, we must attempt to estimate the effect of a Federal tax upon the price and yield of State and local bonds in the light of what we can observe to be happening now with respect to those securities in comparison with private securities.

This will answer your question directly, sir.

I have concluded, simply on the basis of the current spread between private taxable securities and exempt public securities—I mean State and local securities—that the effect of the present burden of Federal tax is equivalent to a spread of from 90 to 100 basis points, in other words, from 0.9 to 1 percent in the interest rate. In other words, a city which could borrow today at 3 percent would be obliged to pay 4 percent if its bonds were taxed. If its credit is good enough to let it borrow at 2½ percent today, it would be 3½ percent if the bonds were taxable. The evidence of that is in the spread and changing the spread between the yields of taxable and exempt securities. The support for that spread is found in the comparison between average bond yields as quoted by Moody's Investor Service.

That is the spread between the yields of municipal bonds and of industrial and public-utility bonds.

Senator TAFT. How can you compare those?

Mr. LUTZ. Beg pardon?

Senator TAFT. You mean you are comparing city bonds that are not a general obligation with industrial bonds?

Mr. LUTZ. Well, these municipal bonds which are selected by Moody's for the purpose, I presume, are general obligation bonds.

Senator TAFT. How can you compare the bonds of the city of Cincinnati with the bonds of the Cincinnati Street Railway Co.?

Mr. LUTZ. I do not know that Moody has chosen those in particular. The underlying basis, Senator Taft, is the rate. A triple-A bond, municipal or industrial, is presumed to be more or less on the same investment basis, so far as investors are concerned.

You might make an argument that a triple-A municipal bond is better for many reasons than a triple-A industrial, and, in some cases you could get away with it, but in other cases, there might be some question in the minds of investors.

Senator TAFT. I do not see how you could compare them.

Mr. LUTZ. I am not attempting to make any specific comparison of particular issues.

Senator TAFT. How do you account for the fact that any funds that are tax exempt still invest in municipal bonds?

Mr. LUTZ. I do not believe I got the point of your question.

Senator TAFT. The charitable funds that are exempt, the income is still invested in municipal bonds.

Mr. LUTZ. You mean rather than in industrial bonds?

Senator TAFT. I mean is invested in municipal bonds rather than in industrial bonds.

Mr. LUTZ. In some cases—take the savings banks, the trust funds, the sinking funds, and other investment funds, there are some statutory limitations on the character of the investment that they may make.

Senator CONNALLY. Right there may I suggest a good comparison would be the Federal Government's own security following the World War at which time there were 3½-percent tax-free issues and 4¼ and 4½ taxable bonds. If you invested in those bonds, you would find that the 4¼ tax bonds were selling below par and it took three-fourths percent additional interest to get them sold. The 3½ tax-free bonds were selling way above par. I do not care to take up any more of your time.

Senator TAFT. They became rare. There was a great scarcity of 3½-percent bonds and the totally exempt Federal bonds. They were very scarce and there was a tremendous demand for them.

Senator CONNALLY. I suggest that in answer to your question.

Senator TAFT. That would be a fair basis.

Senator CONNALLY. There was an exact security of the same governmental unit. That is the only kind of exact comparison you could make.

Mr. LUTZ. You would have, in that case, bonds that were identical in every other respect.

Senator CONNALLY. That is right.

Mr. LUTZ. The point Senator Taft is making is that presumably, there are points of difference between municipal obligations and private obligations.

Senator CONNALLY. There certainly are. Of course, these foundations buy these municipal bonds because they consider them better

security, even though the interest may be lower, whereas the private company may go into the hands of the receiver, may go busted.

Mr. LUTZ. Yes.

In the case of the municipality, the burden of local taxation may rise to a level at which the municipality is obliged to default on a substantial part of its current debt service. We have seen that thing happen in years past.

Senator CONNALLY. That is possible, of course.

The CHAIRMAN. All right, Professor.

Mr. LUTZ. Well, taking this reported average yield of industrial and utility bonds on the one hand and municipal bonds on the other, we get for 1941 a differential in yields which will range from 93 basis points in the case of industrial over municipal to 111 basis points in the case of public utility over municipal.

I have used, for the purpose of being extremely conservative, 90 points. I think it might be as much as 100 points difference. I have made no attempt to revise that estimate in the light of the proposed additional tax rate in the pending bill, but obviously if levels of taxation such as are there proposed go into effect, the spread will undoubtedly be much more than that.

We then face the question of how this differential is likely to affect the cities, and there we have to speculate a little about the course of the rate of interest in the future.

As you know, we have had for 10 years a very cheap money market. It has been, to some extent, a manipulated market. It is likely to continue to be a manipulated market. It is not a normal capital market.

There have been various forces and influences which have tended to keep the interest rate low.

As to the future, we face two possibilities: First, will that cheap money market continue indefinitely, or will the controls presently either be relaxed or will they fail?

In that case we will go back to an interest-rate level more nearly approximating that of the First World War and the period immediately following. In either case, I think the burden of the cities eventually is going to be very much the same, but it will operate in different ways. First, if we assume that a 2½-percent market is going to prevail indefinitely, then the cities are going to be burdened negatively by the tax, because if their new bonds and their refunding bonds are made taxable, they will be barred from taking advantage of a 2½-percent market in the new issues and in the refunding issues.

So you can think of their burden then as a lost opportunity burden. If they cannot come in with new borrowing at levels of interest to which they would be entitled on the basis of their security, in view of the general market, because of the tax, then they are just out of luck by that much.

If, however, the interest controls are ineffective or are removed and we get back to a 4 percent level for Federal money, then we may expect the taxable municipal bond instead of being secured at 4 percent to go on up to 5 percent.

So I think we must face the prospect of an additional burden upon the cities regardless of the course of interest rate in the future. Obviously, if we consider the 100 basis points additional cost to States and cities, the over-all cost is going to be that addition multiplied by the amount of taxable bonds that they will sometimes have outstanding.

While we know nothing now about the volume of debt which the cities and States are likely to have in the future, if we should estimate a time when they have an outstanding taxable debt equivalent to the present volume of exempt debt which is roughly 19½ billion dollars, you can see readily that at 1 percent the added annual cost of carrying such a debt would be something like $195,000,000. If we take 90 basis points as the minimum addition to that, it will be something like $175,000,000 added interest burden to the State and cities.

Senator VANDENBERG. And will the heavily increased loads of taxation, on the other hand, substantially increase the value of the exemption privilege?

Mr. LUTZ. You mean as the Federal tax rates go on up?

Senator VANDENBERG. Yes.

Mr. LUTZ. It would tend to increase the value of that exemption privilege on outstanding bonds, as long as there are outstanding exempt bonds.

Senator VANDENBERG. Yes.

Mr. LUTZ. That, of course, is a mere matter of mathematics. It is perfectly obvious that would be the case.

Senator BROWN. Why would not it affect the interest rate on bonds to be hereafter issued? Going back to Senator Vandenberg's point on the 1939 rates, which of course were very different from the 1942 and 1943 contemplated rates, a man with a $100,000 income on the 3 percent State of Oklahoma bonds would have to get an industrial security bearing 7.32 percent interest to get the same net result, after consideration of taxes. If he had $1,000,000 net income or a net yield of 3 percent on State or local securities, that is the equivalent of an industrial security yielding 12.5 percent.

A 4 percent State bond yields just as much as 16.68 percent taxable security. Of course, if that was true in 1939 that condition is certainly greatly aggravated by our present rate or future rate. I agree with my colleague. I do not see but what that will have some effect toward lowering the interest rate on future issues of the local governments.

Mr. LUTZ. Well, that might be true if you had enough people with million-dollar incomes, who were putting all of their money into that kind of security. The difficulty with that kind of demonstration is that it is a demonstration on paper, which does not have a very close connection with reality, because there are only about 50 or 60 people in the United States, perhaps less than that now, who have million-dollar incomes.

Senator BROWN. It is pretty conclusively demonstrated by the estate-tax figures in 1938. On estate taxes of $5,000,000 and over 44 percent of all the property was in the shape of totally tax-exempt securities.

Mr. LUTZ. How many of those were there in that?

Senator BROWN. I do not know how many, but there were a substantial number. Likewise, as you go down the list half a million and up over 10 percent was in the form of totally tax-exempt securities. I readily grant that there are a large number of holders of these bonds that are not in those brackets.

Mr. LUTZ. Yes.

Senator BROWN. I do not think you can entirely eliminate that factor on the point you are making.

Senator GERRY. Is not there a question involved in that for the reason that those estates are trying to be liquid? They are investing in securities that they can turn over quickly and not to have securities, the value of which is hard to determine because the tax is so high?

It may be more than 100 percent. I think that comes into your estate-tax question.

Mr. LUTZ. You may be right. I cannot tell you what the motives are by which anyone with a large estate buys this, that, or the other security.

I think we are in danger, however, Senator Brown, of exaggerating the significance of these securities in the large estates.

As you know, we made a pretty careful analysis of that estate-tax matter.

Senator CONNALLY. They are not exempt from the estate tax.

Mr. LUTZ. No; they are not exempt from the estate tax. The point that is so often made is that rich people invest large amounts of their assets in State and municipal bonds for the purpose of securing exemptions from income tax.

The figures do not bear that out. I will concede, because the evidence is clear on the point, that there are cases of such conversion, but to say that it is wholesale conversion, or to say that there are large numbers of large estates which have been converted into tax-exempt securities, is certainly not true on the basis of the evidence from the estate-tax records.

The best way to look at that is to look at the over-all picture. One statistic does not prove a point. When you take the whole story of the estate-tax records since 1926 and look at all of the estates subject to Federal or State estate taxes, you will find that only about 6 percent of the gross estates out of 120,000 estates that have gone through the Federal revenue mill since 1926 have invested in State and local bonds, and more than 50 percent of their gross estate has been invested in the stock, common and preferred stocks of American business.

I am content to rest the argument, so far as the estate tax is concerned, on that showing. I think, by and large, it is a minor matter. I am not denying. I would not attempt to deny that there are individual cases in which there has been extensive conversion, but, looking at the whole picture, I think it is relatively insignificant by comparison with other aspects of the subject.

Senator VANDENBERG. I agree completely with the fundamental philosophy presented by all the witnesses, but the point that bothers me is the one that Senator Brown has so well illustrated. It seems to me, with these tremendously increased tax burdens, we are creating a new value for this immunity, which was never enjoyed before, never contemplated, an immunity which grows out of the war effort. It just does not seem quite fair to me that that portion of the immunity which grows definitely out of the war effort should not well be geared to the war effort in the tax bill.

That is the only problem that there is, so far as I am concerned.

Mr. LUTZ. Let us see what the situation is with respect to that. As I take it, your view is that with the growing of Federal taxes, the people who seek this immunity from those taxes will insist on pushing the interest rate down, and down, until the outcome which I

anticipated, namely, of the heavier borrowing cost to the States and cities will not result.

Have I stated your difficulty?

Senator VANDENBERG. Putting it the other way round, I mean, if you continue to have your total immunity under the impact of these extraordinary war taxes, your immunity acquires an artificial extra value which is the direct result of war conditions.

You get your money so much cheaper than ever before, there would be no comparison between the cost normally and the cheaper cost thereafter.

Mr. LUTZ. But is not the value of that immunity, with which you are concerned, limited really to a comparatively small number of persons?

Senator VANDENBERG. I do not know. I am perfectly willing to hear you on the subject, but that is the issue, as far as I am concerned.

Mr. LUTZ. As a matter of fact, we do not have precise knowledge as to the distribution of the holdings of State and municipal bonds. We do know that upwards of two-thirds of the amount now outstanding, and perhaps fully two-thirds, is held by financial corporations of various types, banks, savings banks, insurance companies, and other financial institutions, and also by various trust and investment funds, and that would leave, at the most, not more than one-third of the outstanding total to be owned by individuals.

Senator BROWN. What do you figure to be the total amount? About 17 billion?

Mr. LUTZ. No; the total amount of State and local bonds would be in the neighborhood of 19½ billion.

Senator BROWN. 19½ billion?

Mr. LUTZ. Yes. The largest figure that I have seen, whether by the Treasury or by anyone else, would place not more than 7 billions in the hands of individuals. And, I think Mr. Jeffries will insist, from his point of view and the studies he has made that that figure is probably too high as representing the proportion owned by individuals. It is pretty clear, from the evidence of the estate-tax records, that not all of that is owned by persons with very large incomes.

Consequently, I am forced myself to the view that the range of persons or investors for whom the immunity would acquire greatly increased value is rather small, both as to the number of such persons and as to the proportion of the total debt that would be affected thereby.

Senator TAFT. But, Professor Lutz, does not that disturb this interest rate again? If two-thirds are held by people to whom it makes very little difference whether they have municipal bonds or anything else, then are not they going to take some amount of municipals, whether they are nontaxable or whether they are taxable?

Mr. LUTZ. No.

Senator TAFT. It seems to me if there is not this large tax exemption, then there is no reason for the difference in rate.

Mr. LUTZ. On that basis you may argue, Senator, that a Government trust fund, or a Government sinking fund which buys these bonds could afford to neglect the tax in the price they pay. Or you might say that a mutual savings bank, which under present law is exempt from taxation, could ignore the tax in buying these bonds and could afford to price them regardless of the tax.

Now, that is not true unless, and only unless, it is their firm intention to hold those bonds to maturity at the time they acquire them, because if they ever later consider the possibilities of selling those bonds on the market, then they come up against a purchaser who must take account of the tax, and the seller has no option but to resell the bond and take the loss in the price adjustment that the purchaser will insist upon because of the tax.

I do not think any of these exempt or nontaxable institutions or anybody else who is unaffected by the tax presently, can afford to ignore that market situation.

Senator TAFT. They do not ignore it, of course. The fact they are willing to buy them even though they are nontaxable and pay the higher price brought about by that fact, it seems to me would indicate your estimate of one-half of 1 percent is high.

Mr. LUTZ. Let us take the situation in 1941, Senator. When you had the Federal taxes at that time, you had not yet gotten into the war effort. As a matter of fact, the actual spread between industrial bonds of comparable grade according to Moody's rating and municipal bonds, triple A, double A, and A bonds, according to figures which the Secretary of the Treasury himself inserted in the hearings before the Ways and Means Committee, the average spread in the year was 0.86; in other words, 86 points.

Senator TAFT. I do not want to dispute the fundamental basis of that. I do not see how you can compare the municipal bonds with industrial bonds. Just because some rates on both are considered triple A, I do not see what difference that makes.

Mr. LUTZ. I will put it as the average of triple A, double A, and A, however that might be. One might dispute the inferences from the evidence, but I do not think one can dispute the evidence, because the evidence is apparently a matter of record, compiled by agencies whose concern it is to report the facts.

The fact is that the average spread was about 86 points for the year.

Senator RADCLIFFE. Professor Lutz, in accounting for the spread of 1 percent, how far does the element of uncertainty as to what the rate of taxation is going to be enter into it as a fact? Of course, if you know the tax is going to be a certain amount, you can easily figure the difference to you between the taxable and nontaxable security, but if you must estimate, you are going to have to go on the fact that the rate of taxation is going up, in regard to the amount.

It seems to me that element of uncertainty would enter somewhere there in helping to increase the factor of spread.

Mr. LUTZ. It might. But, of course, Senator, you must bear in mind that investors are buying all the time, every day; they are buying private securities which are taxable, and the general effect of the market forces produces a certain level yield of the taxable securities. At the same time, they are buying the other bonds, the municipal securities which are not taxable, and they are establishing, as a matter of record, a certain differential.

Now, Senator Taft insists that other factors than the tax enter into that. That may be. The determination of the part which the tax plays and the part which other factors in the minds of investors

play is one which I do not think anybody can sort out, except in a very rough and haphazard way.

What we do know is, given the actual course of the market, you get these differentials. On that basis, if we assume that the conduct and attitude of investors is going to be more or less uniform in the future with what it has been in the past, I think we may anticipate a continuance of differentials which are, to some extent, certainly influenced by the course of the tax.

Therefore, it is perfectly obvious that if we do impose the tax, we are certain to deprive the cities of the opportunity to borrow on more favorable terms by at least the amount of the market differential which you now have, whether that is produced entirely by the tax or by the tax and other considerations. Therefore, with the added burden upon the local taxpayers, it can only be approximated by dimensions which are indicated by the present spread. That, at any rate, is the best manner of approaching this subject that I have been able to devise.

Senator RADCLIFFE. If you buy a tax-free security, you know definitely what your income is going to be. If you buy a bond that is taxable, you have to speculate.

Mr. LUTZ. That is true.

Senator RADCLIFFE. As long as you have to speculate, then, it seems to me that element of speculation may come into the matter of either depressing or increasing what you are going to pay.

If you have an optimistic frame of mind, you hope the tax will be lower, but if you are a pessimist, you would likely base it on an increased tax.

Mr. LUTZ. There are both pessimists and optimists on that subject.

Senator RADCLIFFE. I think the element of uncertainty would, in some way, figure in it to help account for the spread. I do not know how much, but it is reasonable to assume that is an element somewhere.

Mr. LUTZ. Yes; I think that is true. Is there anything further? Shall I go on?

The CHAIRMAN. Yes.

Senator BROWN. I would like to add one figure there, Senator.

I asked the Treasury to tell me what the effect on Federal securities was of the elimination of the tax-exempt feature.

Of course, it is very difficult to arrive at a figure, because there are so many factors in the picture, principally the factor of the growing scarcity of the wholly tax-exempt Federals, but their spread is 39 points, based upon the same basis that you based your 90 points.

The Treasury's estimate before our committee was around 25 to 30 points; the difference between you and them is some 60 points.

The actual experience in the Federal picture, they tell me, is 39 points.

Mr. LUTZ. What securities are you referring to?

Senator BROWN. Those are all securities. That is the issue of September 15, 1944.

Mr. LUTZ. You mean it is a Treasury note?

Senator BROWN. Yes.

Mr. LUTZ. Bearing three-fourths percent interest?

Senator BROWN. Yes.

Mr. LUTZ. I am amazed that it is as much as 39 points or a three-fourths percent rate of interest.

Senator BROWN. The figures they have given to me show taxables 91, the yield on tax-exempt 52, making a difference of 39.

Mr. LUTZ. That is a coupon rate of three-fourths percent.

Senator BROWN. That, of course, is partially due to the growing scarcity of tax-exempts.

Mr. LUTZ. If you blow that up to 2½ percent interest, you get a spread of about 1 percent.

Senator TAFT. The table attached to your notes shows 5 points difference between taxable and tax-exempt Treasury notes.

Mr. LUTZ. What table is that, Senator, what page?

Senator TAFT. On the last page.

Mr. LUTZ. No; the spread is shown in the line at the bottom, the average. We took two issues there and averaged them, and you will see that it ranges from 20 to something more than 30 points.

Then, in the cross-hatched line is the amount of tax that would be payable on a three-fourths percent coupon at the corporation rates prevailing during that period.

Senator TAFT. Yes; but up above you have two lines comparing the taxable and tax-exempt securities.

Mr. LUTZ. Those relate to two issues, two of which are taxable, and two others of which are exempt.

Senator TAFT. So the difference there is 15 points.

Mr. LUTZ. The difference is shown in the curve at the bottom part of the page labeled "basis points."

That is the spread. We average the two taxable issues, and two exempt issues as to price and then take the difference between those prices, and that gives you the curve at the bottom of the page which ranges, as you see, starting at 20 points differential in December and goes up to more than 30 points in March and April, and then sags again, and in November 1941 it sags a little below, almost back to 20 again.

Senator TAFT. It is also true that spread is determined by considerations given by the banks, not by private investors.

Mr. LUTZ. That is true.

This is simply a matter of the corporations, the taxes that investor corporations have to pay.

The CHAIRMAN. All right, Mr. Lutz. You may proceed.

Mr. LUTZ. I have one other point, Mr. Chairman. The question of the estimated Federal revenue which might be expected. I have laid down the assumption that the cost to the States and cities would range from 175 millions to 195 millions, according to the differential and the income which the Federal Government might expect to obtain at 1941 rates would range from 158 millions, if we assume the continuance of the low interest yield, and therefore small interest payments, up to some 193 millions.

It is likely therefore, that the Federal revenue would approximate the additional cost to the taxpayers. In other words, we would be taking from Peter to pay Paul, and we would take from Peter about as much as we would pay to Paul.

Since I have taken so much time, I want to read just one final paragraph here.

Senator VANDENBERG. You are not talking about Mr. Randolph Paul on this subject?

Mr. LUTZ. I thought of that myself, Senator, but I decided not to mention it.

I think your point is interesting.

It must be noted, also that the burden of the Federal tax on State and local bonds would be laid on the local taxpayers at a time when they are to be subjected to heavier Federal taxes which are levied directly upon their incomes, their businesses and their consumption; further, it should be pointed out that the conditions produced by the war will tend to dry up certain sources of revenue formerly available to States and cities, thereby bringing out an added concentration of the State and local tax load.

The decline of gasoline tax and of motor-vehicle licenses is illustrative. As these, and possibly other revenues shrink, the States and cities face a curtailment of essential services, or a further increase of taxes on property.

In some cases, a revival of State-wide levies on property may become necessary. The net effect of the Treasury proposal is to cause a substantial increase in local taxation, falling chiefly upon the property taxes, at a time when property owners face the prospect of assuming a larger share of State and local government costs.

Senator TAFT. There will be practically no municipal bonds issued during the war, or very little probably, so there will be very little additional cost during the war.

Mr. LUTZ. That is true, but earlier in the statement I made the point that the present levels of present taxation and possibly still higher levels will continue for a fairly long time after the war. How soon gasoline revenues will come back nobody knows, and the same is true as to some of these other sources of State revenue.

Therefore, you are facing the prospect of imposing a heavier burden on local taxpayers merely as a means of the roundabout collection of the tax at a time when they are subject to a very much heavier burden.

In conclusion, Mr. Chairman, the Treasury proposal, as a fiscal measure, comes to this: It will increase local taxation by about as much as it increases the Federal revenue. The real effect of such a tax is not to be measured by the amounts that may be collected from the several bondholders, but by the amounts to be collected from local taxpayers.

In an effort to apply progressive taxation to a minor fraction of the interest paid on State and local bonds, the proposal will really result in greater regressiveness in the local taxes and particularly the property tax.

The CHAIRMAN. All right. Thank you very much, Professor.

Senator DANAHER. One question, please.

The CHAIRMAN. All right, Senator.

Senator DANAHER. Professor Lutz, is there any other source of income to the individual or corporate holder, that is a corporation subject to tax, which is tax exempt?

Mr. LUTZ. Other than these municipal bonds, and other than the partially exempt Federal bonds, offhand, I think of none other.

Senator DANAHER. The whole question turns then on the public policy.

Mr. LUTZ. It is a matter of public policy.

I certainly agree with what Mr. Tobin said, that the fundamental issue in this whole matter is not the revenue, and it is not the question of what happens to a few individual investors; it is the question of what is going to happen to the States and cities.

That, after all, I think, is the crux of the whole issue. If we sacrifice the freedom and independence of State and local government, we shall be doing ourselves a very great disservice.

The CHAIRMAN. All right, thank you very much.

(The following brief was submitted by Mr. Lutz:)

BRIEF BY HARLEY L. LUTZ, PROFESSOR OF PUBLIC FINANCE, PRINCETON UNIVERSITY

In 1939 I presented to the Special Senate Committee on Intergovernmental Taxation the result of a detailed study of the fiscal and economic aspects of the taxation of interest on public securities. That testimony is a matter of record, and if the members of this committee would like to have that detailed study made available, I can supply additional copies. At this time, however, I propose to review the earlier arguments in the light of the changes which have occurred since 1939 and to summarize briefly the findings and conclusions as they emerge from this current study of the situation.

The economic issues are the same today as they were 3 years ago. They are:

(1) The extent to which the tax on State and local bonds would be shifted to the debtor governments.

(2) The effect of such shifting upon the exercise of the borrowing power of State and local governments.

In approaching these issues, attention must be given to the following significant changes since 1939:

(1) The Federal income taxes upon both individuals and corporations are much heavier than in 1939.

(2) The prospect is for their further increase, and we can hardly hope for lighter taxes during the next generation than we are now paying.

(3) The long-range prospect of heavy Federal taxes means that the ordinary financing of State and local government will involve a greater burden than was anticipated in 1939.

(4) Therefore it is necessary to consider most carefully any proposal that is likely to add to this burden.

An estimate of the extent to which the tax on State and local bonds will be shifted to the debtor governments requires consideration of the reaction of the holders, or the prospective purchasers, of such securities once they have been made taxable. As prudent and sensible men, they would make every effort to protect the yield on their investments.

Obviously, they will demand a higher yield from municipal securities, and the leverage which they can use to secure that higher yield is the return that can be obtained from private bonds. As a result of these decisions by investors, the investment yield on all bonds of a given grade, both public and private, would approach a fairly uniform level; that is, instead of buying municipal bonds on a tax-exempt basis to yield 1.75 percent (the average yield of municipal bonds rated by Moody as Aaa, Aa, and A, in 1941), the investor would do one or the other of the following:

(1) He would tend to price municipals on a yield basis in the neighborhood of 2.71 percent (the average yield of industrial bonds rated by Moody as Aaa, Aa, and A in 1941); or

(2) He would turn to the private bonds which, at a yield of 2.71 percent for industrials or 2.78 percent for utility bonds, would leave him a larger return after taxes than he would have from municipals bought on any lower-yield basis.

I submit for the record a table showing the annual averages of bond yields, 1937–41, as reported by Moody's Investor Service, with the differentials between the yields of industrial and public-utility bonds, on one hand, and of municipals on the other. It may be noted, incidentally, that the average differential between municipals and industrials and public-utility bonds in the years 1937–39 confirms my earlier estimate of a minimum-yield spread of 0.60 point under the tax rates of that period.

Annual average of bond yields, 1937–41, with the differentials between the yields of municipal bonds and industrial and public utility bonds, respectively[1]

[Data supplied by Moody's Investors Service]

Year	Yields				Differentials in yields		
	Municipal	Industrial	Public utility	Average of industrial and public utility	Industrial over municipal	Public utility over municipal	Average of industrial and public utility over municipal
1937	2.80	3.31	3.55	3.43	0.51	0.75	0.63
1938	2.59	3.17	3.40	3.28	.58	.81	.69
1939	2.41	2.98	3.14	3.06	.57	.73	.65
1940	2.13	2.76	2.97	2.86	.63	.84	.73
1941	1.75	2.71	2.86	2.78	.96	1.11	1.03

[1] Averages of bonds with ratings of Aaa, Aa, and A.

This table reveals the downward movement of all bond yields in recent years, regardless of their taxable status. This movement is a product of various influences. It is well known that the broad program of Government financing for a considerable time to come involves the maintenance of low interest rates, and it is also well known that the Treasury and the Federal Reserve banks possess ample powers to assure the continuance of this condition. I shall show presently that this has a significant bearing on the problem.

The rise in the average yield differential between private and municipal bonds of comparable rating from an average of 66 basis points for the years 1937–39, inclusive, to 73 basis points in 1940, and 103 basis points in 1941 reflects the effect of the increasing taxes during this time. In view of the present and the probable future Federal tax situation, and in view also of the yield differential which the market has established in response to that tax situation as it has developed, I conclude that the added cost of State and municipal borrowing, under present tax conditions, would be of the magnitude of 90 to 100 basis points, and for the purpose of a conservative estimate of the aggregate added burden I have used 90 points, or 0.9 percent. During the recent hearings before the Ways and Means Committee Mr. Paul stated that Treasury studies indicated a spread of interest rates between taxable and nontaxable bonds of one-quarter to one-half percent.[1]

This was the Treasury position in 1939, and, as I have shown, the market record for the years 1937–39 revealed an average spread of 66 points, or 0.66 percent. It was my position then that the Treasury experts were underestimating the effects at that time. Surely, we have a strong case for a still greater spread today in view of the tax changes which have occurred in the last 3 years.

Indeed, the Secretary of the Treasury has provided such a case in data which he submitted to the Ways and Means Committee on March 3. I refer to a comparison of the yields of high-grade corporate and municipal bonds, on page 70 of the hearings on the Revenue Act of 1942. There the spread between the yields of municipal and corporate bonds was shown to range, in 1941, from 0.63 to 1.01, and the average for the year was 0.86 percent.

The transfer of the tax to the debtor government is well demonstrated by the record of the price and yield differential between taxable and exempt Treasury notes. This record is graphically shown in the accompanying chart. It establishes the truth of the following comment made by the New York Times of December 11, 1940:

"If the new notes had been issued tax-free as usual, the rate necessary would have been one-half percent, the taxable feature making for the difference of one-quarter percent in annual interest."

The measure of the added interest cost involved in carrying a taxable debt equal to that now outstanding is the face amount of State and local debt multiplied by the rise in the cost of borrowing each dollar of that debt. The total increase in cost on this basis is shown in the following table.

[1] Hearings before the Ways and Means Committee on Revenue Revision of 1942, p. 69.

Estimated increase in the cost of State and local debt, resulting from the removal of tax immunity on the basis of an average increase of 90 points in long-term yield basis

Debtor division	Outstanding debt, 1940 (millions)	Increased interest cost (thousands)
States	$3,273.2	$29,459
Counties	2,036.2	18,326
Municipalities [1]	9,511.0	85,599
Townships	279.7	2,517
School districts	1,698.6	15,287
Other subdivisions	2,530.8	22,777
Total	19,329.5	173,965
Territorial and insular	153.0	1,377
Grand total	19,482.5	175,342

[1] Includes cities, towns, boroughs, and villages. Debt totals by debtor divisions from Bureau of Census, State and Local Government Special Study No. 13, State and Local Government Debt, 1940, p. 26. In addition to the interest-bearing debt, a total of $355,206,000 of non-interest-bearing debt was reported for 1940. Of this total, $249,000,000 consisted of contractual obligations of western irrigation districts of the U. S. Bureau of Reclamation. Much of the remainder consisted of matured debt not yet presented for payment on the date for which the statistics were compiled.

It should be emphasized that this estimate is based on the assumption that future issues only are to be taxed. The complete demoralization of the municipal bond market that would be produced by subjecting outstanding issues to tax would undoubtedly cause a much greater differential for a considerable time, and would therefore cause a substantial increase in this cost.

This demoralization would be the natural result of subjecting to tax a great mass of securities which had established a market price and yield basis without regard to the tax. Inevitably there would be heavy selling of municipals, both by institutional investors and by individuals. Because of the circumstances which gave rise to this selling, namely, the imposition of the current Federal taxes and the prospect of such further increases in the Federal taxes as may be enacted, it is very doubtful if adequate support for the municipal bond market would develop until the prices had declined to levels which represented some discounting of the future tax trend.

It is necessary to recognize two different ways in which the States and cities may be affected by this increase in cost. I have referred to the prospects of a long-continued easy or cheap money market, and to the stake which the Government has in perpetuating low-cost money. Time alone can show whether interest rates will be held at their present levels or will be allowed to rise. We have, therefore, alternative ways of looking at the situation from the standpoint of States and cities. These are:

(1) If the present low-interest rate level is perpetuated, then the effect of the tax would be to prevent the States and cities from taking full advantage of the cheap money in their refunding and new borrowing. In this case the cost of the tax could be described as a "lost opportunity cost." Instead of borrowing or refunding at rates consistent with the low prices of money, they would be obliged to pay an additional ⅛ to 1 percent because of the tax. That is, they would be denied the opportunity of saving money in the low-rate market.

(2) On the other hand, if the cheap money controls are not effective, or if they are relaxed, and if the general interest level rises, then the effect of the tax would be to compel States and cities to increase their bond coupon rates. In either case the effect of the tax will be to increase the cost of borrowing by as much as ⅛ to 1 percent, but under one assumed condition, it will mean the inability to effect a saving in interest costs, while in the other it will mean an increase in the actual dollars of interest paid.

My present estimates of Federal revenue yield take into account these two extremes with respect to the future of the interest rate. Under the first condition, the Federal revenue would be $158,700,000 at the 1941 rates, and under the second, it would be $193,400,000. If interest rates actually should take a middle course between the current low level and that which prevailed

during and after the first World War, the Federal revenue would be between these outside estimates, an average of which is $176,000,000. In short, it seems likely that the Federal gain will about equal the local taxpayers' loss, and that the proposal to tax State and local bonds will result in collecting, by way of the bondholders, an additional tax of this amount on the State and local taxpayers.

I pass, finally, to brief consideration of the effects upon the borrowing power of the States and cities. The character of the State and local long-term debt is shown in the following table:

Character of long-term debt	Amount [1] June 30, 1940	Estimated annual increase of interest caused by an additional 99 points in the cost of borrowing [2]
General obligations	$16,672.0	$150,048
Revenue bonds	1,778.0	16,002
Special assessment	879.9	7,919
Total	19,329.9	173,969

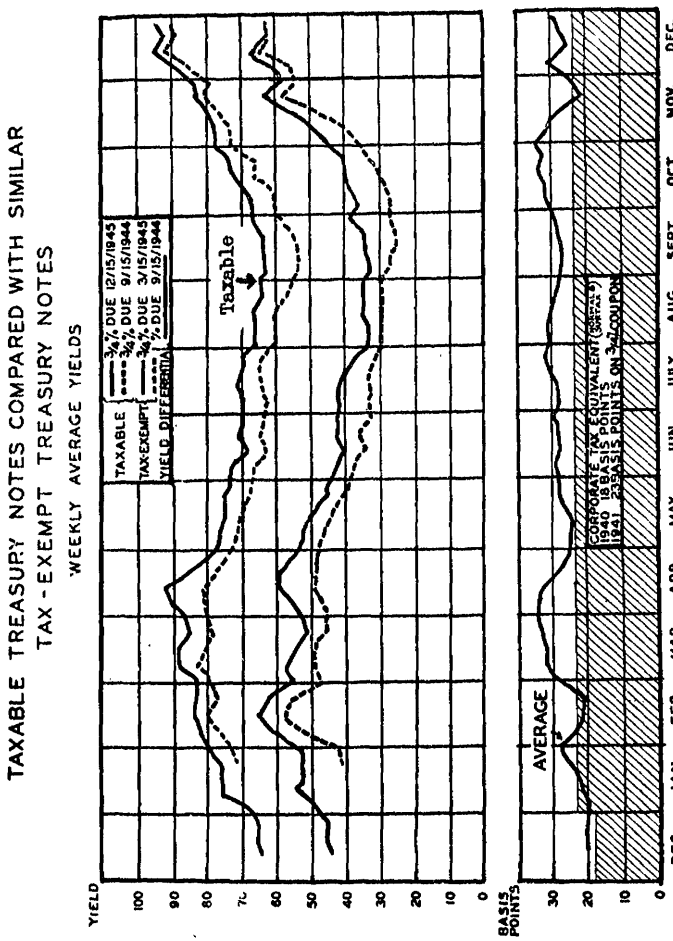
[1] In millions.
[2] In thousands.

From this classification it appears that about $150,000,000 of the annual increased cost will fall upon the general taxpayers who support State and local government, while some $24,000,000 will fall upon the users of special services or upon property owners in higher costs of local improvements to property.[3] Obviously, the ability to borrow on the security of revenue bonds will be severely curtailed by a substantial increase in the cost of capital funds. Therefore, the freedom of States and cities to enter upon self-liquidating projects, in which the prospective revenues must service the debt, will be greatly curtailed. Insofar as the provision of services of this character is a proper and legitimate function of State or local government, the inability to do so because of the added cost of capital financing, caused by the Federal tax, constitutes an impairment or local government function.

With respect to the effect of the part of the tax which will be borne by general taxpayers, it is apparent that the increase in the cost of funds which I have indicated will restrain many governmental units in their discharge of general services or functions involving the exercise of the borrowing power. It is not the function of either the Congress or the Treasury to determine, for any State or city, that local services which may require the aid of borrowed funds may not henceforth be undertaken, or if done, that the cost to the citizens shall be increased inordinately beyond the terms that would be available to a free government in the market.

At the same time, there is growing pressure upon States and cities to make greater provision for the aid and protection of the people during the war. This will lead to larger cash expenditures, first, to expand local service facilities such as sewers, streets, police and fire protection, and other services for the war industries and their employees; second to do their share for civilian defense. They are expected to be amply prepared to deal with fires that may be caused by incendiary bombs; their police must be ready to maintain order during the turmoil of air raids; they must safeguard water supplies, provide air raid shelters, and arrange for civilian evacuation, emergency feeding, first aid, and many other things. A substantial part of this cost must fall on local budgets, and thus, finally, on local taxpayers.

[3] The debt supported, actually or nominally, by the revenue from public-service enterprises is greater than the $1,778,000,000 of revenue bonds shown in the above table, but all such debt for which general funds are contingently liable is classified by the Census Bureau as a general obligation.



The CHAIRMAN. Professor Fairchild.

Mr. TOBIN. May we ask your indulgence to break the order again and put on at this time Mayor LaGuardia and Mayor Jeffries of Detroit?

I think it is satisfactory to the other witnesses.

The CHAIRMAN. All right, Mr. Tobin. The only thing is we are not progressing very rapidly here on the subject. I am afraid you are going to get us confused rather than help us very much.

Come around, Mayor LaGuardia. We will be glad to hear you, sir.

STATEMENT OF HON. FIORELLO LaGUARDIA, MAYOR OF THE CITY OF NEW YORK

The CHAIRMAN. Mayor, how are you, sir?

Mayor LaGUARDIA. A little worried and harassed.

The CHAIRMAN. All right, Mayor, you may proceed.

Mayor LaGUARDIA. I appear as president of the United States Conference of Mayors. Mr. Chairman and gentlemen, we have appeared on this subject so often that I fear some of us have become a little stale on it.

Misery likes company, and I have never felt so much relieved as I have since I have been reading the tax bill before you. I have been struggling to raise about $680,000,000 a year to run my town, and I thought I had troubles; but, gentlemen, I sympathize with you in the tax that you are now grappling with.

This taxation of municipal bonds has been kicking around for many years. It started shortly after the last World War, and its origin was entirely different then than it is now. I will tell you how it started. Just before the World War, municipalities were going into the acquisition of their own water supply, power, and transportation, and this baby is that of the utilities. That is how it came to the House shortly after the war, on a constitutional amendment—you were there, Senator [referring to Senator Connally]—and then Representative Ogden Mills, who sponsored the constitutional amendment, took the baby with him over into the Treasury Department, and it has been there ever since.

Senator BROWN. It has grown quite a little since.

Mayor LaGUARDIA. Yes; but no one will admit its paternity now.

Senator BROWN. I am glad to have the information.

Mayor LaGUARDIA. Every Member of the present Senate who was a Member of the House then, voted against it.

Now, when we first attacked this, we did it on constitutional grounds. Now that is kind of shoved aside, and the Treasury raised the fiscal reasons for it.

Professor Lutz testified that there are about $19,000,000,000 outstanding of State and municipal bonds, in answer to a query.

I have about $2,400,000,000 of that amount in New York City. Of course, we have property back of it.

The whole matter, gentlemen, is very simple, unless the semicolon boys of the Treasury Department seek to involve it.

There is no gain for the Federal Government if you tax these securities. There is disaster for the municipalities if you do.

Now, let us have no illusions about it. We get nothing for nothing. If these securities are taxed, we pay for them. The taxpayers of the municipalities pay for them, not the rich guy that these youngsters from the Treasury Department seek to use as a climax to a speech.

We have heard them all. We have heard all of these youngsters from the Treasury Department, and they just do not know.

Municipalities do not issue bonds for the fun of issuing them. We do not like to issue bonds, but we do sell bonds when we are required to do so for capital outlay. Some municipalities have been compelled to issue bonds for the care of the unemployed in recent

years. In many States, municipalities cannot issue bonds for current expenses; they can only issue bonds for capital outlay. I am referring, of course, to long-term indebtedness and not certificates issued in anticipation of tax collections.

I took some part, when a Member of the House, in the consideration of and passage of tax bills. I never defended the big-income group.

This idea that all the municipal and State securities flow into the portfolios of the coupon cutter is again incorrect. The individuals in the higher group have their interest. They are in oil; they are in steel; they are in automobiles; they are in industry. They do not dump their own investments in business of their own, just to buy municipal or State securities.

Mr. Lutz, in one of his statements before the several hearings we have had on this subject, pointed out very accurately that the estates that have been closed or probated upon which taxes have been paid, indicated the small percentage of outstanding State and municipal securities were in their portfolios.

The Senator from Ohio pressed the question as to the difference between a high-grade industrial and a State or municipal bond, and the answer to that, Senator, is, I think, very simple. Given an equal credit standing, the municipal is preferable for the simple reason that the faith and credit of the municipality is back of it. In other words, when New York City issues a bond for its subway construction or its water supply system, it is not only that property back of it, but the faith and credit of the city, and the taxing power of the municipality and the debt service is over and above any constitutional tax rate that may be allowed to the municipalities.

Therefore, it is almost a guaranteed return, unless the whole municipality blows up, as we may unless our problem is understood by you gentlemen in Congress.

Gentlemen, there is not a city in this country that is not skating on very thin financial ice. The cost of municipal government has increased. You gentlemen see that in your own appropriation bills. New functions are thrown upon municipal government. Our main source of income is our tax on real estate, and you all know how that has depreciated.

So we are just all up against it for revenue. Now, you slap an additional expense in the debt service, which reflects on the tax rate.

Gentlemen, remember this: That the interest, the amortization on our bonds is not within the tax rate limitations provided in State constitutions. It is over and above and every cent of Federal taxes imposed upon the income of the bonds will reflect in the interest rate which we must pay, which, in turn, reflects itself in the tax rate on real estate which is now overburdened.

Heretofore; we were making a constitutional argument, but when we are on the verge of a financial break it is a matter of municipal life or death with us. How long we can continue to run our cities depends on how far we can put additional burdens on the taxpayers of the cities.

Now, if there is any fun, if anybody gets any pleasure in seeking to add additional burdens on an already overburdened real estate and such limited other sources of revenue that a city has, well, let him make the best of it, but we, as mayors, do not and cannot print

money; you do not permit us to. We haven't unlimited credit. Our credit is limited by the State constitution to a certain percentage of the assessed valuation of taxpaying property within the city.

So we are in a limited confine as to revenue.

In answer to your question, Senator Connally, as to what is a government function, well, we had all sorts of tests on that. There were those who contended that water supply was not a government function, and we had to go to the Supreme Court on that question. Is a bridge, is a tunnel a government function? A bridge is no longer a luxury. Where you have a city of 7½ million people, such as we have in New York City, the transporting of those people every day from home to work and from work to home is a matter of life itself, and we must provide the transportation.

Is light, is heat a function of government? Very often municipalities are compelled to go into these activities because of local conditions.

Is a swimming pool a municipal function? Our health authorities say that it is. Is housing a municipal function? Now markets: We must have municipal markets, we must have them for the proper distribution of food and for providing a proper price scale in the retail cost of food.

My city is no different from other cities in that respect. All these new activities are coming up on us with the trend of the times.

May I refer to another subject in the bill which affects the cities?

The CHAIRMAN. Yes; you may, Mayor.

Mayor LAGUARDIA. I want to point out this, gentlemen, on the collection at the source:

We have 165,000 employees in New York City. That is going to throw an additional cost on us for the administration of collecting the tax at the source, and it is no small item.

If it is to be deducted at the source, I hope you gentlemen will bear that in mind. It is not just a question of deducting it and letting it go at that. And, if I might say so, it is an additional cost to all employers. We are all now overburdened with paper work. There is the liability compensation; there is unemployment insurance; there is the social security—all this requires a great deal of clerical work, and if New York City has to assume this with 165,000 employees, it is going to cost a great deal of money.

First, it is going to cost $200,000 to make the mechanical changes on our check machines; then I figure it will cost us about $150,000 to $200,000, maybe more, a year to make this deduction.

I just wanted to point that out at this time.

Now, if I may refer for just a moment to another thing; I assume, of course, that the future economy of the country has been considered in the presentation of this bill. Just what that economy will be, I do not know, because my job now is to clean the streets of New York, remove the sewage, and that kind of thing.

But I do want to point out this, that with the rate here—and I am not opposing it—I see very little possibility of continuing to put 10 percent of one's income in savings, in War stamps or War bonds. When you get into these schedules here and the tax is taken out of the salary, it just is not there to invest in bonds.

Now, if I may suggest, I think perhaps the rate might be increased a little bit, perhaps 1 percent and 25 percent of the amount paid

returned to the taxpayer in a nontaxable, nontransferrable, nonattachable, and nonassignable certificate, payable say a year or a year and a half after the war.

Otherwise, we will find ourselves in a position with millions of men unemployed, with no income, the revenue will diminish and no reserve.

We must pay for the war, of course, but we must be thinking also of what is going to happen after this war is over. There is going to be a condition here that is more frightful to me than the war itself.

We all know we are going to win the war. It is going to take longer than some people believe. It is going to cost more in lives and blood than most people hope now, but, eventually, we will win it.

Then, after that is over, here is a problem that requires very careful consideration, and if we are going to use all of our resources at this time without making any provision for the future, without giving the opportunity to the average wage earner in this country to set aside something for those days that are coming, when employment will be scarce in this readjustment period, coming back to normal production from war production, we are going to have a very difficult time. That is why I urge this committee to give very serious consideration in providing some reserve through this very medium that you have before you, in first getting a certain amount which we need for the war without interest charges, and at the same time providing that reserve that we necessarily must have, because none of these groups, until you get to the very high income, will be able to provide any reserve or any saving under these rates.

Senator VANDENBERG. That would especially hit small business very hard, would it not?

Mayor LAGUARDIA. I do not know what is going to happen to small business, gentlemen.

To be perfectly frank about it, the situation is very critical. First we have that group of small business that depends upon consumers' goods, the manufacturing of these consumers' goods and selling these consumers' goods, that cannot manufacture them, everybody knows that, because you cannot get the raw material. So they are up against it.

Then you have the others that might do something, that because of the necessity of speed and urgency in getting war production, are now sort of crowded out. The Congress has provided the Small War Corporations Act, which will take time to get started.

There will not be very many small manufacturing plants or shops if the war continues 3 or 4 years. No one today would say it is going to be over in 1943, if he knows what he is talking about.

We have that situation. We have the industrial situation; we have the trade and business; then we have transportation, and that is all Government now.

The railroads are getting a shot in the arm, because it is all war transportation at this time.

It is just like making coffee with the same grounds over and over again. The time comes when you do not get much coffee out of the grounds. If all we have now is being kept alive with Government money because of war requirements, then the time is going to come when we will be just absolutely flat.

Anyone having any relation at all with government knows the necessity for it, that this after-the-war problem should be given a great deal of consideration.

To come right back to the taxing of municipal and State securities, if we are going to be burdened with that additional cost, every penny will come from the taxpayers of the city and that one source of revenue, because that is our main source of revenue, the real-estate tax.

We have license fees and other taxes which go into the general fund, but the main source is from that one, the real-estate tax.

Senator CONNALLY. May I ask you a question there? How has your sales tax worked in New York? Is it a pretty good revenue producer?

Mayor LAGUARDIA. Yes; it is just as good locally as I said it would be bad nationally when I opposed it in the House.

Senator CONNALLY. I am speaking not about the national sales but of the city sales tax.

Mayor LAGUARDIA. You see, I enacted the sales tax when I got the power from the legislature for additional funds. The revenue was earmarked for relief.

We went as high, Senator, as $72,000,000 or $73,000,000 a year for relief. That was our share, gentlemen, in addition to W. P. A.

It ran along there for a while from $72,000,000 to $74,000,000.

Senator HERRING. What percent is that?

Mayor LAGUARDIA. 2 percent sales tax.

Senator HERRING. I was speaking of the whole, the percentage that you put up and the W. P. A. put up; about 4 percent, was it not?

Mayor LAGUARDIA. No, no. You see, in addition to W. P. A. we had families on home relief that we provided for.

Senator HERRING. We all did.

Mayor LAGUARDIA. We all did. We contributed it entirely. We got 40 percent from the State. We are on the 20-percent basis contribution in the W. P. A.

Senator HERRING. That is 45 or 50 percent in some of the other States.

Mayor LAGUARDIA. Did you have home relief?

Senator HERRING. No; we did it ourselves.

Mayor LAGUARDIA. So did we. We collected, Senator, on the 2-percent basis about $45,000,000 or $50,000,000 on the sales tax.

Then we had the utility tax, then we had the cigarette tax, and then we had the business tax. The State took the cigarette tax away from us so that is gone. And we reduced the 2-percent sales tax to 1 percent.

It was originally earmarked for 8 years for relief. Now we must provide relief in the annual budget, and that revenue goes into the general fund.

Senator DAVIS. What is the number of persons unemployed in New York now, Mayor?

Mayor LAGUARDIA. I think in New York we have now about 350,000 heads of families who are unemployed, and the sad part of it is that a large number of these unemployed are skilled workers in the building trades and in manufacturing trades.

You see, we are a very large light manufacturing center, and that is just killed now and we are up against it pretty hard.

The CHAIRMAN. Anything else, Mr. Mayor?

Mayor LaGuardia. No; I haven't anything else; unless there are more questions.

The Chairman. Any questions of the mayor?

Mayor, I might say that I am agreed 100 percent with your statement about the necessity for reserves. I do not think we can afford to lose sight of the post-war problem here that we will face. We can go as far as we can in raising current revenue, but we cannot destroy the future.

Mayor LaGuardia. We should not.

The Chairman. No.

Mayor LaGuardia. Don't destroy the future of the cities, gentlemen, I beg of you. I hope I will not have to appear on this subject again.

The Chairman. Thank you very much for your appearance.

Mayor Jeffries?

STATEMENT OF HON. EDWARD J. JEFFRIES, MAYOR OF DETROIT, MICH.

Mayor Jeffries. Mr. Chairman and gentlemen, I am here in a dual capacity. I represent the American Municipal Association, which is an association of State municipal leagues.

There are 42 States in the Union that have municipal leagues and they have—I suppose you might call it—a chamber of commerce of municipal leagues called the American Municipal Association.

Each of these State municipal leagues has gone on record unanimously in opposition to the taxing of either presently existing or outstanding municipal and State bonds, and also future issues of State and municipal bonds.

I have here about 10 sample resolutions. As I say, each one of the State municipal leagues has passed a resolution to that effect, and I will leave them with the clerk when I leave.

In addition to that, of course, I represent the city of Detroit, which is fundamentally and tremendously affected by this program.

In the first place, I have listened to the gentlemen who have testified before, and the thought seemed to occur to me, at least, that so much is said about the theoretical side of this proposition and so little has been said about the actual, practical side of the operation of these cities, that perhaps I can bring another phase to the attention of you gentlemen.

Senator Vandenberg and Senator Brown both questioned Dr. Lutz about whether or not this was not an unusual exemption to give to States and municipalities at this particular time, because to continue the tax exemption would be even more important to investors, and I suppose inferentially to the municipality because of the rising Federal taxes, and for that matter, the rising of State and municipal taxes.

I think that we would get an increased benefit because the scarcer and fewer tax-exempt securities there are, the more valuable they become to the holder, and therefore we have a right to expect that we would get an even lower interest rate than we have.

Now, it has not worked out universally that way to date. I think it is common knowledge that the interest rate for State and municipal securities is probably, practically speaking, at an all-time low.

Let me give you a practical illustration of what it has meant to the city of Detroit.

All of you gentlemen remember we ran completely out of money back in 1933, primarily because our debt service charge was so great that the city could not possibly meet it. We refunded and the bulk of our refund went to callable bonds, due for the most part, in 1962 and 1963.

We have been, practically speaking, ever since refunding the so-called refunding bonds. To date we have saved by refunding at lower interest rates than we received at the time, more or less as a result of a shotgun refunding upward of $80,000,000, which over the space of time involved means an actual reduced operating cost to the city of Detroit of about $4,000,000 annually.

That has been a marvelous thing to Detroit, because it has actually reduced its operating cost by that amount of money, made it possible to raise money easier, and in addition to that, has contributed no end to right our financial picture.

We, of course, needless to say, would like to continue that. The fact of the matter is, our only regret is instead of saving $4,000,000 we do not save $5,000,000 or $6,000,000 a year because today, with a large-scale refunding program behind us, with some odds and ends yet to do, but the bulk of it completed, we find that 20 percent of the cost of our operation actually is a debt service charge, and in spite of the fact that we have had all sorts of unusual burdens placed upon us in the operation of our city.

Let me name some of the things, Senator, that will offset——

Senator BROWN. Mayor Jeffries, may I interrupt you a moment?

Mayor JEFFRIES. Yes.

Senator BROWN. I wanted you and the committee to know that in the report of the special committee in 1939, submitted to the Senate, we came to this conclusion with respect to this refunding:

> Where an issue now outstanding may be refunded at a lower interest rate because of the present low money market, we would permit the refunding of any tax exemptions now permitted of existing issues, limited as to final maturity date as were the original bonds.

That was the recommendation of the committee.

Mayor JEFFRIES. Yes, Senator Brown. I had read about that in the newspapers, and I just read it in the report, but that does not seem to me to be all of the answer. It seems just as important to me that future issues be tax exempt as that refunding issues be exempt, because it all goes to the cost of the operation of local government.

Let me call the attention of you gentlemen to a local picture. I talk best about the thing that I know the best. That is about the operation of the city of Detroit. While it is just a segment of the whole country, it is a fair example.

This war effort has made it necessary for us to have a great deal more police protection. The Army hesitates none to call up and say, "We have got to have more people here, we have got to have more people there; we have got to have more people here," and because we are as interested as anybody else in seeing that that protection is granted we have to supply that. That is true of fire, that is true of housing, that is true of welfare, that is true of civilian defense, that is true of health and recreation, in fact, all of those activities are at a

tempo that we have never maintained before due almost exclusively to the war effort.

In addition to that, we find that the Federal Government, on their cost-plus contracts, their subsidation of private industry, their tax exemption of the local war industries in the community have so tremendously increased the cost of wages, the cost of everything that goes into the war picture, that we are in competition with it, and we find ourselves whipsawed in between the fact that you folks are going to raise, on the one hand, our cost of operation by eliminating a privilege that we have enjoyed—well ever since the beginning of the country——

Senator TAFT. Mayor Jeffries, I do not quite understand the "war" argument because I do not think you are going to issue any new bonds other than refund bonds. I do not think they will let you do it.

Mayor JEFFRIES. That is the reason I am so scared of you gentlemen.

Senator TAFT. As a post-war picture I think it is a legitimate argument, but as far as the extra war expense is concerned I do not see how anything we do here is going to increase the expenses of the city of Detroit during the next 2 or 3 years, or if so, at least in a negligible way.

Mayor JEFFRIES. Senator Taft, I agree with what you say. That is what scares us so much of you gentlemen. Are you like the Fuller brush man trying to get your foot in the door this time?

Senator TAFT. You are making the argument that because of the war expense now, we should not be burdening you.

I am just questioning the validity of your argument about increasing the municipal expenses. This bill is not going to increase your present municipal expenses.

Mayor JEFFRIES. It will, sir; because it is not possible for us to operate our Government without borrowing money at some time during the year.

Senator TAFT. But that borrowing will be very limited. You can issue bonds only for capital improvements. That is true with us and I suppose that is true with you.

Mayor JEFFRIES. Senator, we are just like the Federal Government. We set up a tax bill and we bill the general public for it. If we have any additional expenditures—and I do not imagine any Government agencies are able to go through a fiscal year, in the last few years and I presume the next years to come would be able to estimate in advance a year to a year and a half in advance, all of the expenses they are going to have to meet, and therefore there are unusual expenditures each year that we have not appropriated for; plus the fact that taxpayers do not pay exactly on the date the tax is due, and therefore we have to meet operating expenses every year that were not anticipated.

I think every year in the history of the city of Detroit—I cannot go too far, of course, but every year for the last 20 years, it has been necessary for us to borrow money at some period during the year, what is called in the trade, short-term borrowing.

Senator TAFT. You borrow that from the banks, do you not?

Mayor JEFFRIES. Yes, sir; we do that.

Senator TAFT. I do not think it would cost any more.

Mayor JEFFRIES. Well, I am quite sure it would, because were not there figures quoted here just a moment ago on that—on what the Federal Government had to pay on their short notes?

Do they pay the same now as they did?

I also want to say the difference between the Federal Government and the city government is that the Federal Government has its own Federal Reserve System which literally controls the interest rate. We have to go out in the open market.

We are victims of the circumstance, as has been said here, of the Federal Reserve System.

Senator TAFT. We neither borrow money for current expenses, nor do we borrow short-term money, but the amount, in your case, would be negligible. The difference in interest in dollars would be nothing.

As far as taxing present bonds is concerned, it would be a long time before it is in effect.

I think your argument should be directed to post-war conditions in cities, not to the fact that you have extra policemen now.

Senator RADCLIFFE. Will you have much refunding?

Mayor JEFFRIES. In the future?

Senator RADCLIFFE. In the immediate future.

Mayor JEFFRIES. Not much, sir. Most of it has been completed; in fact the great bulk of it. We just have some tag ends to take care of now.

Incidentally, we refunded about $200,000,000 worth of bonds in the last 6 years, maybe 7 years. Most of that has been completed. As far as that is concerned, we are not nearly as worried about that particular phase of it as we were last year, and the year before.

Senator TAFT. What is the total debt?

Mayor JEFFRIES. About $350,000,000. Let me say, Senator, that I am one individual who is diametrically opposed to the Federal Government taxing municipal securities.

Detroit is a city that has enjoyed home rule for about 100 years. We feel that it is a privilege that is most enjoyable.

I am still naive enough to believe in democracy, that all of the things we tie onto our present war effort are based fundamentally on the right of municipalities to enjoy a certain amount of home rule, and with the invasion from each of the four corners of the Federal Government and State governments into the realm of municipalities, it does not seem to me that we are doing well in the continual fight to maintain the theory and philosophy of home rule. As I say, the thing that discourages me and worries me more about the attitude of Congress in relation to the taxation of municipal securities in the future that is perhaps it is like the Fuller brush man, that they are trying to get their foot in the door so that at a later session, it is quite simple to tax existing bonds.

As a practical fact, it would not increase the cost of the operation of municipal government a whit if the municipal bonds that were already outstanding were taxed, because insofar as we are concerned, that is water over the dam.

The real thing that worries us is the taxing of the future municipal securities.

The city of Detroit, for instance, as I said, went very broke in 1933, and has been literally living, for the last 10 years, with a tightened belt. We had to postpone many capital improvements that we would like to enjoy. We had to postpone many major maintenance items that perhaps might be described as penny-wise and pound foolish, but we had to do it because, as a practical fact, we did not have the money to do it.

We are just getting to the state, in fact, we are just now at the state, if it was not for the fact that we could not get material and supplies, where we can do many things that have been postponed for the last 10 years.

To increase the cost of financing, however, in the future, as I presume this war will not last indefinitely, does not seem to me to be the thing to do, because, as Mayor LaGuardia said—and it is more true in Detroit than in any other community—that, by any away, the bulk of the revenue that the municipality receives comes from the real estate tax, and the attitude of the Treasury Department worries me no end.

We were the particular victims of the proposed treaty that was gotten up by the Treasury Department to exempt from taxation the British Purchasing Commission. We have a very large plant in Detroit that is manufacturing Rolls Royce motors. We have been trying for the last 2 years plus, to collect taxes from them.

The Treasury Department is so anxious, with one hand, to eliminate exemptions; while on the other hand, they are promulgating, attempting to have passed a treaty which would actually exempt from all local taxation, a local industry, if you please.

It is true that part of the motors were going to England, but at the same time, it was supplanting an economy that we had for these many years, been subsisting on.

Senator VANDENBERG. Did it encourage you a little that they did not get far with it?

Mayor JEFFRIES. No end, Senator. Let me bring you down to date on the story.

It is true that the treaty did not pass, but it is equally true that the Packard Motor Co. have gone through their factory and tagged every bit of machinery and every bit of produce in there that belongs to the Packard people under their label and labeled each one under the label of the British Purchasing Commission, every bit of machinery and produce that goes to them, and we are not able to collect the tax.

The fact of the matter is the British Purchasing Commission has simply taken the attitude it was not worthy of appeal. They just do not pay—period. We get no reaction from them. They do not pay, and by now they owe us a million dollars in taxes, in spite of the fact that the contract that was written between the British Purchasing Agency and the Packard Motor Co. called for a fluctuation according to the cost of material, the cost of labor, and the cost of taxes.

I guess they think that must have just been put in as a standard form that was used some other place, because they apparently do not pay taxes.

This whole attitude scares the life out of Detroit as a municipality because it seems to us as though there is a gradual plan to squeeze us right out of business, and at the present trend, the only logical culmination is that we are out of business.

We are suffering, and we will suffer no end from the absorption of the taxing field by the Federal Government and limiting in every way the field of the municipal organization, and these added burdens are continually being placed upon us.

We have taken the pitcher to the well too often and sooner or later, our main source of supply will break down. It did in 1932, 1933, and 1934. It has revived, and currently, we are doing all right, but we are maybe doing a little bit of crying now before we are out of business, because then it would be too late; however, we are afraid to cry too loudly.

We would like to have you gentlemen appreciate that the practical problem of raising the cost of operations of the municipalities is often more difficult than it is, it seems to me, to raise money for the operation of the Federal Government. At the same time, I do not want you gentlemen to misunderstand us. We pay to the Federal Government now 2 to 3, to 4 times as much in the way of taxation as we do to our municipal government, and I do not know of anybody that is complaining overly much about it, but it does seem to us that the taxation and the raising of revenue by the Federal Government on our municipal securities is like raising yourself over the fence by your own bootstraps, because it will be the same people who pay the taxes, by and large, and it will increase the cost of the local operations.

Now, everybody knows that the Federal Government is charged with the responsibility of maintaining this country at the best level possible; that is, the best possible level to the rest of the world, and what the people of this country want, and it would seem to me that the thing to do is direct to the public and tax them, rather than go for taxes to the people and make them, in turn, go to the same people that the Federal Government goes to, because it will be our citizenry in Detroit that will have to pay this additional load.

The people that you use, as an example, the wealthy man who purchases municipal securities, or any other kind of securities, does not buy them on the coupon rates, he buys the securities on the net yield to the investor and if they are taxable, then he is interested, I repeat, only in the net yield, and we, in effect pay the tax, and we, in effect, spread that tax upon our local citizens, and it comes back to the old, old story, and in our particular case, it goes to the real-estate owner. I do not know what the future holds. We may, at some later date, have to have another source of revenue, we probably will, at least, that will be my guess.

Senator BROWN. Your problem is fundamentally more difficult than the Federal problem, because your bonds have definite constitutional limitations.

Major JEFFRIES. Senator, I agree with the fact that the Congress, the Federal Government controls our economy. They have the Federal Reserve System, they control the banks, they can set any interest rate they desire. We have to go out on the open market. It would seem to me that the Federal Government security is still the prime security in the country and that States and municipalities are still secondary to the Federal Government.

Senator BROWN. And you do have constititutional limitations.

Mayor JEFFRIES. Yes; except they can be changed. It may be impractical, and it is certainly highly difficult, except that could be changed, and I presume if the situation got black enough some change would have to be made, except that we always are secondary to the Federal Government.

It seems to me like you are picking on a cripple when you pick on the municipality or the State, because you are the supreme governmental authority in the country, and you do have all the machinery in order to be able to raise money. We are subservient to the financial picture that you folks set here. That is why we are so anxious that you do not set one that will take an undue advantage of us. I do not mean undue advantage of us because we do have, in the same way as anyone else has, we have a privilege that it literally traceable, in dollars and cents, to the advantage of the operation of the States and municipalities.

The financing cost of one of these cities is an important fundamental part of the cost of the operation, and whatever you do to it, will raise the cost.

Gentlemen, I have watched the municipal money market like a hawk here for the last 2 or 3 years because of the fact that we were in a huge refunding program, and, believe me, when I say every time the Senate Finance Committee, or any committee of Congress, or any important member of the Federal Government had anything to say about the taxation of municipal securities, it just plays them up and down like you would a piano or an organ, and we, the cities, are the recipients of it. When Mr. Morgenthau made a speech in Cleveland our bonds dropped off a quarter point. We were just about to come in with a refunding issue. I am not sure that we will ever regain the position that we were in last fall before Mr. Morgenthau started to talk so strongly about the taxation of municipal securities. It does translate itself directly into the cost of the operation of our government.

Senator RADCLIFFE. What percentage of your municipal securities are owned in Detroit, do you imagine?

Mayor JEFFRIES. I am not sure, sir. As a practical fact, I did a little proselyting throughout the country in trying to sell our refunding issue.

I suppose the majority of them are held perhaps in the East. A couple of times a refunding issue was underwritten by Chicago. The fact of the matter is one issue was participated in by some west coast banks, bond brokers, or peddlers. It was hailed as the first time in the history of the city that the west coast gentlemen participated in it.

So I would presume, by and large, they are held around in our area and in the East. Mr. Tobin tells us that our comptroller issued a statement not long ago that the best estimate we can make is about 8 percent of our bonds are more or less locally held.

Senator RADCLIFFE. Insofar as they are not held there, then you would not say you would get back by way of taxation anything to offset the increased interest rates you would pay?

Mayor JEFFRIES. We would not get it anyway, because it goes into the Federal coffers.

Senator RADCLIFFE. You would not have any local taxation at all, then?

Mayor JEFFRIES. We would get no proceeds from the local tax, and we would have to stand the full 100 percent burden locally of the increased financing charge as the result of the decrease in the net return.

Senator RADCLIFFE. Insofar as the Federal tax is concerned, you would not get anything back.

Mayor JEFFRIES. No.

Senator RADCLIFFE. If you imposed a system of local taxation you would only get back, insofar as the proceeds on your own securities are concerned, you would only get back that part of it which would be a small part of the total?

Mayor JEFFRIES. That is about as broad as it is long. The reason the Federal Government is interested, from the point of view of revenue, is because these are not their bonds. The fact of the matter is when they put a tax on their securities the interest rate went up.

I am not sure whether their tax was as much as the increased cost or not, so one about washes out the other, except insofar as the Federal Government is concerned, there is no washout. We, the municipalities, pay the increase, and they, the Federal Government, get the full return.

Senator RADCLIFFE. If you taxed them, it would be only partially washed out?

Mayor JEFFRIES. Yes; it would be only partially washed out. Even so, it would be washed out equally as well for the net yield as for the increased tax.

The CHAIRMAN. Are there any questions? Is there anything else, Mr. Jeffries?

Mayor JEFFRIES. I cannot think of anything, Mr. Chairman. I hope I have covered it. I would like to add this—that we have this other problem that is becoming alarmingly important, and that is the tax exemption of Government and war industry facilities in our area. It seems to us that it has increased manyfold, and that in the immediate future, along about our next tax year, it is going to have a tremendous effect upon us. While this is a little off this picture, yet it is all wrapped up in the same picture, and I certainly would like to urge you gentlemen's earnest attention to the problem of eliminating the source of income of cities and the increase in our cost of operation. Sooner or later that margin will become so narrow that we are going to have some sort of break down.

I will leave with the clerk the resolutions from the State municipal leagues.

Senator DANAHER. What facilities, local facilities, have we exempted, Mr. Mayor, from local taxation?

Mayor JEFFRIES. Your War Industries Corporation and the various agencies you set up for the prosecution of the war in order to protect themselves have written into their contracts the fact that the property immediately passes to the Government upon delivery.

That immediately removes from the tax roll the facilities and the raw materials, and those things that go into the war industry.

Senator DANAHER. We haven't done that.

Mayor JEFFRIES. Well, sir, Congress has. Maybe the Senate Finance Committee has not, but the Congress has, and I presume you gentlemen have voted on it from time to time.

Senator DANAHER. How extensive is it in Detroit?

Mayor JEFFRIES. Well, a lot of it is yet on paper. That is, the contracts have been entered into but a lot of the stuff has not yet been delivered. For this taxing year we were a step ahead of you; in other words, our due date came before this country got into the all-out effort, and therefore, anything that we can show now is an estimate as to the future, but we feel it will be quite extensive.

You see, we were substituting a war economy for civilian economy and because we have been so highly industrialized that means about 70 percent of our economy is switched into the war effort.

The Government, apparently, makes three types of contract:

(1) A plain contract where the producer keeps his independence and his business as usual, insofar as he is concerned and does business as usual so far as the city and that producer are concerned.

(2) Then they have the cost-plus feature basis. So far as I am able to determine, that has been limited, by and large, in our area to Ford, General Motors, and Chrysler. There have been some additional small contracts but, by and large, the bulk of those are with those three organizations.

(3) Then there is the subsidized industry where the defense plant corporation is the main agency, I think that finances it. In order to protect themselves against other producers, they have written this phraseology into the contract which exempts them, in effect, for all products, machinery, raw materials, so on and so forth. Of course, the Defense Plant Corporation acts specifically, makes liable for taxation the real estate, but the machinery and equipment and raw material, things like that that go in, are specifically exempt, on the theory that they belong to the Federal Government, and as a result, we are unable to tax them.

Senator DANAHER. That is in relation to contracts between the Defense Plant Corporation and local industries that take contracts?

Mayor JEFFRIES. That is just like the Packard Motor Co. They are making the same old stuff, except they are using it for airplanes, and now they are exempt, according to the British Purchasing Agency.

It just puts a hole in our revenue. The industry might as well not have been there.

Mayor LAGUARDIA. That was an amendment to the R. F. C. Act of 1941. We would like to submit a statement on that. It specifically exempts personal property from taxation. They first sought to exempt the sales tax, and the *Alabama case* has held adversely to the Federal Government.

There is a bill now in the Committee on Rules in the House.

Senator DANAHER. That is the Cochran bill. That is the one I thought the gentleman was talking about.

Mayor LAGUARDIA. On page 20 I would like to suggest an amendment, and that is this provision:

> No amendment made by this title shall apply in any case where its application will be contrary to any treaty obligation of the United States.

And, I would like to suggest, "duly ratified by the Senate."

I will tell you why. A treaty has been negotiated between Great Britain and the United States and they may call that an agreement, and to go into court, that costs us a lot of money.

Detroit is involved in this. So, if you simply add here "duly ratified by the United States Senate" that would dispose of that treaty that the Senate has not ratified.

Mayor JEFFRIES. Senator, I might be able to clear that up in your mind. The Cochran bill in its original form, would have eliminated

the possibility of our taxing any war industry within the city of Detroit.

It would have just ruined us, I think.

Senator DANAHER. I know it could have been the House Ways and Means Committee. I thought you were laboring under the misapprehension that we had passed it.

Mayor JEFFRIES. No.

Senator DANAHER. Thank you.

Mayor JEFFRIES. There is this other phase under the present set-up that is not nearly as far-reaching as the original Cochran bill, except it is gradually growing and growing.

That is, we are running into the picture that we cannot even get the break-down between what is civilian economy and what is war work.

Senator VANDENBERG. You mean the British Purchasing Commission is operating on the theory that this treaty has been ratified and is duly in effect?

Mayor JEFFRIES. No, sir; they are operating now on the theory that under international law no government can tax the property of another.

The attorney general of the State of California ruled that they were taxable, and then he changed his ruling on the ground of international law.

Now, they keep citing to us the position taken by the California attorney general. Of course, we just don't agree with the position taken by the California attorney general.

Senator VANDENBERG. In that case, why did they make the treaty?

Mayor JEFFRIES. They wanted to sew it up. I imagine they wanted to leave nothing to the element of chance.

Senator DANAHER. They just do not do anything.

Mayor JEFFRIES. We have gotten to the position where we cannot get any answers from them.

Senator DANAHER. But they just do not pay?

Mayor JEFFRIES. That is correct.

Senator VANDENBERG. That is an international custom.

The CHAIRMAN. Thank you.

(The resolutions referred to are as follows:)

RESOLUTION ADOPTED BY THE AMERICAN MUNICIPAL ASSOCIATION IN CONVENTION ASSEMBLED AT CHICAGO, ILL., ON THE 24TH DAY OF OCTOBER, 1941

Whereas the United States Treasury Department is again proposing the Federal taxation on income of municipal securities on the ground of national-defense need, in spite of thorough consideration and disapproval having been given this matter by the Congress; and

Whereas the practical effect of such a proposal would not provide substantial Federal funds for the defense emergency, because little revenue could be realized from such taxation for a number of years but would, on the other hand, hamper vital municipal services and limit the ability of the municipalities to cooperate in the national defense; and

Whereas the proposal would still further subordinate State and local government to Federal control and destroy municipal autonomy; Be it

Resolved, That the American Municipal Association reiterate its opposition to the proposed Federal taxation on income of municipal securities and urge the State leagues of municipalities to continue their vigilance in the matter.

RESOLUTION BY ARIZONA MUNICIPAL LEAGUE, PHOENIX, ARIZ., ON TAXATION OF MUNICIPAL SECURITIES

Whereas Federal taxation of municipal bonds is unsound in principle and if carried out would be extremely detrimental to the credit and money-raising ability of municipalities in that municipal bonds would be rendered undesirable from an investment standpoint and therefore in many instances unsalable: Now, therefore, be it

Resolved, That the Municipal League of Arizona earnestly endorses the efforts of the Conference on State Defense and all other organizations who are endeavoring to dissuade the Congress of the United States from rendering such bonds subject to Federal taxation.

NOVEMBER 1941.

RESOLUTION BY IDAHO MUNICIPAL FINANCE OFFICERS' ASSOCIATION, EMMETT, IDAHO, ON TAXATION OF MUNICIPAL SECURITIES

Be it resolved, That the Idaho Municipal Officers' Association in convention assembled at Boise, Idaho, on December 13 and 14, 1940, is opposed to the removal of the exemptions on the bonds and securities of States and municipalities, and their agencies, whether now outstanding or hereafter to be by them, or either of any of them, issued, except by their consent, and unless such removal is done by amendment to the Constitution of the United States, and provided that the States, municipalities, and their agencies shall be granted the power to tax Federal securities for revenue sufficient to provide revenue to offset such increased municipal costs, it does now reaffirm its resolution adopted in convention on December 7 and 8, 1938, except insofar as said last-mentioned resolution pertains to the collection of income taxes on the salaries of officers and employees of States and municipalities; be it further

Resolved, That a copy of the above resolution, together with the resolution adopted on December 7 and 8, 1938, be forwarded to Senators John Thomas and D. Worth Clark, to Representatives Henry Dworshak and Compton I. White, to Governor-elect Chase Clark and Attorney General-elect Bert Miller, and to the Conference on State Defense.

RESOLUTION ADOPTED BY THE LEAGUE OF TEXAS MUNICIPALITIES IN CONVENTION ASSEMBLED AT TEMPLE, TEX., ON THE 7TH DAY OF NOVEMBER 1941 OPPOSING THE FEDERAL TAXATION OF THE INCOME FROM MUNICIPAL SECURITIES

Whereas the Congress may again consider the proposition of taxing the income from municipal securities: Now, therefore, be it

Resolved, That the League of Texas Municipalities hereby affirms its opposition to the taxation of State and municipal securities or revenues derived therefrom by the Federal Government; be it further

Resolved, That the League of Texas Municipalities hereby approves the program and objectives of the Conference of State Defense; and be it further

Resolved, That copies of this resolution be sent to the Treasury Department of the United States, to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and to the members of the Texas delegation in Congress.

Passed and approved this the 7th day of November A. D. 1941, in Temple, Tex.

RESOLUTION BY THE LEAGUE OF MINNESOTA MUNICIPALITIES, MINNEAPOLIS, MINN., ON FEDERAL TAXATION OF MUNICIPAL BONDS AND SECURITIES

Resolved, by the League of Minnesota Municipalities, That we deem it in the best interests of the cities and villages of this State and of their citizens and taxpayers to express opposition to the enactment by the Congress of the United States of legislation having for its object the Federal taxation of the bonds or

certificates of indebtedness of cities and villages, or of income derived therefrom, since the taxation thereof can result only in increasing the rate of interest on such bonds and certificates, thereby increasing the tax burden of such residents and taxpayers; and

Resolved further, that the League of Minnesota Municipalities hereby requests the Minnesota delegation in the Congress of the United States to exercise its best endeavors to oppose and defeat the passage of legislation designed to place any Federal tax upon municipal bonds or certificates of indebtedness or upon the income derived therefrom. (Proposed by the League Revenues Committee.)

JUNE 1940.

RESOLUTION ADOPTED BY THE NEW JERSEY STATE LEAGUE OF MUNICIPALITIES IN CONVENTION ASSEMBLED AT TRENTON, N. J., ON THE 14TH DAY OF NOVEMBER 1941

Whereas the Treasury Department has again resumed its campaign of publicity as a prelude to the introduction of a bill at the present session of the United States Congress that will assert the right of the Federal Government to tax income from municipal and State bonds; and

Whereas the imposition of such a tax would cost the taxpayers of our State approximately $7,970,000, and

Whereas the delegation of power to the Federal Government to tax income from municipal and State bonds is an invasion of the sovereign rights of the State: Now, therefore be it

Resolved, by the delegates of the New Jersey States League of Municipalities in convention assembled:

1. That we are representatives of the municipalities of the State of New Jersey oppose any legislation to tax the interest on municipal and State bonds by act of Congress. The imposition of such a tax we maintain to be a violation of the sovereign rights of the States and should be submitted to the States in proper form for consideration of a constitutional amendment.

2. That the executive secretary of the league is hereby directed to forward copies of this resolution to each Senator and Congressman from New Jersey requesting that they oppose any and all attempts to raise Federal revenue through taxation of the income of municipal and of State bonds.

RESOLUTION ADOPTED BY THE LEAGUE OF OREGON CITIES IN CONVENTION ASSEMBLED AT EUGENE, OREG., ON THE 2D DAY OF MARCH 1942

Whereas the American Municipal Association, comprising the federation of 42 State leagues of municipalities, is convinced that the proposal to tax the income of municipal securities constitutes a serious threat to the fiscal solvency of the constituent members, and at the meeting of the said American Municipal Association on November 3, 1939, a resolution was proposed and duly adopted in opposition to such taxation; and

Whereas on May 24, 1940, the League of Oregon Cities at its convention in Seaside, Oreg., approved a resolution to the same effect; and

Whereas national defense calls for a strengthening of local credit, inasmuch as State and local governments are being called on to provide additional police and fire protection, safeguard their water supplies, build additional roads, and undertake other activities for which they must borrow money, and such tax would result in an increase in the interest rate paid by municipalities; and

Whereas the increase in interest rates resulting from Federal taxation of State and local securities would merely impose another burden on the already overburdened property taxpayers; and

Whereas the continued efforts of the Federal Government to enact legislation imposing such a tax on municipal securities jeopardizes local financing of capital improvements and threatens the entire basis of sound municipal policy; now, therefore, be it

Resolved, That the executive committee of the League of Oregon Cities feels that the proposed Federal taxation of municipal securities is unsound and opposed to the best interest of local self-government and as such should not be enacted; and be it further

Resolved, to the end that this view may receive proper attention we recommend that copies of this resolution be forwarded to the members of the Oregon delegation in Congress and the members of the House Ways and Means Committee and the Senate Finance Committee of the Federal Congress.

RESOLUTION BY THE PENNSYLVANIA ASSOCIATION OF BOROUGHS, HANOVER, PA., ON TAXATION OF MUNICIPAL SECURITIES, JUNE 26, 1942

Whereas the Federal Treasury Department is still urging upon the Congress of the United States the imposition of a tax on the income from State and municipal bonds; and

Whereas this association has heretofore gone on record in opposition thereto; now, therefore, be it

Resolved, That the opposition of this association to such proposal be reaffirmed; be it further

Resolved, That the officers of the association be instructed to continue to actively oppose all such proposals.

RESOLUTION AGAINST FEDERAL TAXATION OF STATE AND MUNICIPAL INDEBTEDNESS ADOPTED BY THE PENNSYLVANIA STATE ASSOCIATION OF BOROUGHS AT ITS ANNUAL CONVENTION, HELD IN HARRISBURG, FEBRUARY 27, 28, AND MARCH 1, 1941

Whereas the Treasury Department of the Government of the United States has heretofore expressed to and urged upon the Congress of the United States its recommendation that the evidences of State and municipal indebtedness be subjected to Federal taxation; and

Whereas during the year 1940 the aforesaid recommendation was inquired into and it admittedly became apparent that the burden of any such taxation must necessarily resolve upon the municipalities and State issuing such evidences of indebtedness, and thus add to the burden of real-estate taxation; and

Whereas admittedly real estate is presently overburdened and the taxation upon real estate should be relieved and not added to; and

Whereas such proposal would be contrary to all of our established concepts of constitutional division of powers and independence of functions between the several units of government; and

Whereas the inevitable consequence of any such proposal would be to subject municipalities to the financial domination and ultimate control of the Federal Government, thus tending to destroy the fundamental safeguard of democratic government, the independence of home rule; and

Whereas during the year 1940 committees of the House of Representatives of the Congress of the United States and of the Senate of the Congress of the United States conducted inquiries into the feasibility of such proposal, as a result whereof, in September 1940, the said recited proposal of the Treasury Department of the United States was decisively rejected by the Senate of the United States; and

Whereas notwithstanding such rejection, the Treasury Department of the United States has again urged upon the Congress of the United States its desires for the imposition of said recited tax, this time upon the theory that such tax would be in aid of the defense program of the Government of the United States; and

Whereas the said recited proposal of the Treasury Department bears no proper relation to the defense program of the United States and any increased revenue to the Government of the United States would be diminimous and any such proposal would inevitably tend to destroy the independence of the governmental units designated as local government and would thereby tend to destroy the cornerstone of the democratic principles which it is the avowed purpose of the Government of the United States to defend: Therefore be it

Resolved, and it is hereby firmly and highly resolved by the Pennsylvania State Association of Boroughs in Convention Assembled, That it is the unalterable consensus of opinion of this convention that the position of the Pennsylvania State Association of Boroughs as heretofore expressed in opposition to said recited proposal of the Treasury Department of the Government of the United States be reaffirmed; and be it further

Resolved, That the officers of the State Association of Boroughs be and they are hereby directed to use their best efforts in opposition to said recited proposal; and be it further

Resolved, That a copy of this resolution be transmitted to each and every one of the Members of the House of Representatives and the Senate of the United States representing therein the Commonwealth of Pennsylvania.

(This resolution, on motion of Mr. Julian Barnard, chairman of the resolution committee, was carried unanimously by the 970 delegates of the convention.)

RESOLUTION BY THE LEAGUE OF VIRGINIA MUNICIPALITIES, RICHMOND, VA., ON FEDERAL TAXATION OF MUNICIPAL SECURITIES

Whereas at the first session of the Seventy-sixth Congress an effort was made to impose the Federal income tax on the income received from interest on municipal obligations to be issued in the future; and

Whereas it is conceded by fiscal authorities and public officials that this tax would impose a serious burden upon municipalities by increasing interest rates, thus adding to municipal costs which must be borne largely by real-estate taxes; and

Whereas such a measure by interfering with the operation of agencies of the States would be of doubtful constitutionality; and

Whereas a committee of Congress has been created to study the whole problem of tax revision, including the proposal to abolish the exemption on income from municipal obligations, and will prepare a bill on this subject: Now, therefore, be it

Resolved, That the League of Virginia Municipalities in convention assembled goes on record as opposing the extension of the Federal income tax to the income from interest upon municipal obligations, or the income of municipalities or their agencies by act of Congress or by regulation of the Department of Internal Revenue or by any other method;

Resolved further, That the League of Virginia Municipalities advise the Congressional Tax Revision Committee of its position on this proposal, take active steps during the coming year to protect the interests of the municipalities of Virginia, and send copies of this resolution to the chairman of the Committee on Tax Revision, to the United States Senators and Members of the House of Representatives in Congress from the State of Virginia and to the American Municipal Association, the National Federation of State Leagues of Municipalities.

RESOLUTION BY THE ALABAMA LEAGUE OF MUNICIPALITIES, MONTGOMERY, ALA., ON THE FEDERAL TAXATION OF MUNICIPAL SECURITIES

Whereas the Department of Justice now interprets the decision of the United States Supreme Court in *Helvering* v. *Gerhardt* as holding that the Federal Government has the supreme power to tax all State and municipal employees, and

Whereas all State and municipal employees now face the imminent danger of paying income taxes upon all salaries earned since 1026, and

Whereas the Federal Government now claims to have the supreme power to tax future and outstanding State and municipal securities, as well as the revenues of State and municipal agencies: Now, therefore, be it

Resolved by the Alabama League of Municipalities, acting by its executive and legislative committees in session assembled at Montgomery, Ala., on the 28th day of December 1938, That congressional legislation should be passed at the next session of Congress limiting any taxation of State and municipal officers and employees to salaries which they receive in the future; and be it further

Resolved, That the Alabama League of Municipalities is opposed to the taxation of State and municipal securities by the Federal Government, unless the consent of the States is first obtained through a constitutional amendment permitting the reciprocal taxation of Federal securities, and prohibiting absolutely any Federal taxation of State and municipal revenues, or the revenues of State and municipal agencies; and be it further

Resolved, That the Alabama League of Municipalities hereby opposes the proposed plan of the Federal Government to tax State and municipal securities except by a constitutional amendment and to obtain legislation prohibiting the retroactive taxation of the salaries of State and municipal employees, and to

obtain an absolute prohibition against the Federal Government's taxing the revenues of the States, their municipalities or their agencies; and be it further

Resolved, That certified copies of this resolution be sent to the Attorney General of the United States, to the chairman of the Senate Finance Committee, to the chairman of the House Ways and Means Committee, and to the Members of the Alabama congressional delegation as soon as may be.

The CHAIRMAN. We might be able to proceed with another witness. I am advised nothing has been taken up on the floor, and nobody has asked for any time. We might call Professor Fairchild next.

Before you begin, Mayor LaGuardia has asked for insertion into the record of resolutions from various cities, beginning with the resolution from the city of Philadelphia, and letters from various other cities and individuals, in opposition to this tax on outstanding or future issues.

These will be entered into the record.

(The resolutions referred to are as follows:)

CLERK'S OFFICE, CITY COUNCIL,
Philadelphia, February 26, 1942.

SIR: This is to certify that the following is a true and correct copy of the original resolution passed by city council and approved by the acting mayor on the 26th day of February 1942.

RESOLUTION

Recording the opposition of the city of Philadelphia to the imposition of a Federal income tax on income from municipal securities; and directing the presentation of this resolution to the Mayor for his approval or disapproval.

Whereas, the Secretary of the Treasury of the United States has submitted a proposal to impose a tax on the income from municipal securities; and

Whereas the imposition of such a tax would increase the cost to the city of the refinancing of outstanding securities, and the cost of new securities now authorized or which may be authorized for essential and necessary municipal improvements; and

Whereas any such increase in cost would result in an increase in municipal taxation and would impose an additional burden upon the taxpayers of the city; and

Whereas the increase in cost may be so prohibitive as to prevent entirely the refinancing of existing securities or the raising of new money to finance necessary municipal improvements; and

Whereas the imposition of a tax on the income of municipal securities is, in actual fact, the imposition of a tax on the municipality which issues the securities; therefore

Resolved, by the Council of the City of Philadelphia, That the city of Philadelphia declares its opposition to any proposal to impose a Federal tax upon the income from municipal securities.

Resolved, That the mayor be authorized to send copies of this resolution to the Senators and Members of the House of Representatives from Pennsylvania, and to the members of the House Ways and Means Committee and the Senate Finance Committee.

Resolved, That the clerk of council be and is hereby directed to present this resolution to the mayor for his approval or disapproval.

Attest:

WILLIAM W. FELTON,
Clerk of City Council.

A RESOLUTION BY THE CITY COUNCIL OF THE CITY OF CINCINNATI, OHIO

Disapproving any legislation by the Congress of the United States providing for the subjection of the instrumentalities of State and local governments to Federal taxation.

Whereas council of the city of Cincinnati has been advised that renewed efforts are contemplated to submit legislation before the Congress of the United

States, providing for the Federal taxation of municipal bonds and other instrumentalities of State and local governments; and

Whereas the Supreme Court of the United States has for the period of more than 100 years, consistently ruled that the Constitution of the United States prohibits States from taxing essential governmental instrumentalities of the United States Government and the Federal Government from taxing essential governmental instrumentalities of State and local governments; and

Whereas the operation of said constitutional restriction has been to the financial advantage of both Federal and State Governments; and

Whereas the adoption of the proposed legislation would not only be a violation of constitutional principles, but would be grossly unfair unless Congress at the same time provided for the subjection of the instrumentalities of the Federal Government to State and local taxation; and

Whereas, in particular, in the city of Cincinnati, the Federal Government has refused to recognize its obligation to pay a benefit assessment of $69,091 assessed against its property for the widening and improvement of East Fifth Street or to pay its equitable share of the street-lighting costs along its property, and has obtained an order in the Federal court setting aside and canceling said assessment as being unconstitutional and beyond the power of a subdivision of the State of Ohio to levy; and

Whereas the taxation of municipal bonds would tend to increase the interest rates on such bonds from 0.60 to 1 percent, which increase will be directly borne by the local taxpayers and amount to many millions of dollars more than the revenues which would accrue to the Federal Government; and

Whereas in this time of grave national crisis, the fullest cooperation between the Federal and local government of the United States is essential to the successful prosecution of our common war effort: Now, therefore, be it

Resolved by the Council of the City of Cincinati, State of Ohio:

SECTION 1. That this council disapprove the enactment of any legislation by the Congress of the United States providing for the taxation of essential governmental instrumentalities of State and local governments contrary to the constitutional provisions laid down and maintained by the United States Supreme Court for more than 100 years.

SEC. 2. That the clerk of council be and he is authorized and directed to transmit certified copies of this resolution to the following Members of Congress: Hon. Walter F. George, chairman of the Senate Finance Committee, United States Senate; Hon. Robert A. Taft, United States Senate; Hon. Harold H. Burton, United States Senate; Hon. Robert L. Doughton, chairman of the House Ways and Means Committee, United States House of Representatives; Hon. Thomas A. Jenkins, United States House of Representatives; Hon. William E. Hess, United States House of Representatives; Hon. Charles H. Elston, United States House of Representatives.

Passed, February 18, A. D. 1942.

JAMES G. STEWART, *Mayor.*

Attest:

AL. J. BECHTOLD, *Clerk.*

RESOLUTION BY THE CITY COUNCIL OF BOSTON, MASS.

Whereas it is essential in this grave national emergency that municipalities be permitted the utmost freedom to adapt themselves to the changes in the economy of their citizens consequent upon the war effort of the United States; and

Whereas any additional imposition upon the borrowing capacity of municipalities will curtail such freedom in many important directions; and

Whereas the city council of the city of Boston has been informed that the Secretary of the Treasury has indicated in a public speech the purpose of his Department to attempt to extend to the interest on municipal bonds the provisions of the Federal income tax laws; and

Whereas any such amendment of such laws would increase the burden already borne by the city of Boston and might well result in temporary destruction of its borrowing capacity; and

Whereas the said city council is informed that the advantage to the United States from such a change is not to any degree commensurate to the disadvantage to the city of Boston or to the other municipalities of the country;

Now, therefore, the city council of the city of Boston protests against any amendment to the Federal income tax laws subjecting the interest upon its bonds to such taxation, and hereby requests the Representatives in Congress of the citizens of Boston to oppose the enactment of any such legislation.

Adopted unanimously.

RESOLUTION No. 22104 OF THE COUNCIL OF THE CITY OF PORTLAND, OREG.

Whereas there is indication that certain agencies of the Federal Government are renewing their efforts to attain passage by Congress of legislation which would impose a tax burden upon State and municipal securities, including the imposition of a tax upon such securities which are now outstanding, even though the imposition of such a tax would impose tremendous financial burden upon those taxpayers who are called upon to support units of local government, and particularly in a community such as the city of Portland, Oreg., where the bulk of taxes levied for municipal purposes is a direct charge upon the realty and imposes a very definite burden upon the owner thereof; and

Whereas this increased burden upon local financing can only be reflected by an increase in the interest rates which local taxpayers will be called upon to pay; and

Whereas even if reciprocal tax authority is granted to the States for the purposes of taxing Federal securities, the same would be of no benefit to political subdivisions of the State, including municipalities, and would benefit the States only to the extent to which Federal securities are held within their boundaries and would, as a matter of fact, be of particular benefit only to those States in the eastern part of the United States where the bulk of Federal securities are held as investments; and

Whereas repeated efforts in the past to obtain passage by Congress of legislation which would burden State and municipal securities with a Federal tax have met with failure as a result of the Members of Congress realizing that such a tax would be an unfair burden upon the taxpayers of the States and political subdivisions thereof; and

Whereas the Council of the City of Portland, by motion regularly adopted December 26, 1940, has gone on record as being opposed to such a program by the Federal Congress, and

Whereas copy of such motion has heretofore been forwarded to the Oregon delegation in Congress and the members of the House Ways and Means Committee and the Senate Finance Committee: Now, therefore, be it

Resolved, That the Council of the City of Portland, in regular session assembled, does by this resolution reiterate its opposition as voiced by the motion adopted December 26, 1940, to a program of Federal taxation of State and municipal securities as it appears is now contemplated, and does by this resolution renew such opposition particularly in the light of the present emergency and the burden imposed upon units of local government carrying on their civil-defense program and in their many activities conducted in conjunction with the national-defense program for which the local unit of government obtains no compensation; and be it further

Resolved, That a copy of this resolution be entered upon the minutes of the council and copies be sent to the Oregon delegation in Congress and to the officers of the United States Conference of Mayors (Paul V. Betters, executive director), National Institute of Municipal Law Officers (Charles S. Rhyne, executive director), both of 730 Jackson Place NW., Washington, D. C., and to the members of the House Ways and Means Committee and the Senate Finance Committee of the Federal Congress.

Adopted by the council, February 5, 1942.

WILL E. GIBSON,
Auditor of the City of Portland, Oreg.

RESOLUTION OF THE COMMISSION OF THE CITY OF BIRMINGHAM, ALA.

Whereas it is obvious that the economic effect of Federal taxation of the income from municipal bonds would be the exaction by bondholders of interest rates upon future issues of municipal bonds sufficiently high to exonerate them from the burden of such taxation, and to cast such burden upon the general revenues of the issuing municipalities; and

Whereas such Federal taxation would amount to no more than disguised Federal taxation of the tax revenues of municipalities, and would be but another step toward destruction of the sovereignty of the States and their instrumentalities; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time, and no appreciable amount of revenue for a very long time to come, but would immediately very substantially increase the cost of necessary municipal borrowing; and

Whereas Secretary Morgenthau's proposal to also tax income from local Government bonds now outstanding would clearly be on the part of the Federal Government a violation of implied contract rights on the part of the purchaser and holder of those bonds, and which implied rights have been recognized for many years by the Federal Government; and,

Whereas such a breach of good faith on the part of the Federal Government, would be one of dishonor, and would serve to impair the confidence of the people in their Government's pledges: Therefore be it

Resolved by the commission of the city of Birmingham as follows:

1. That this commission do, and it does, hereby, express its determined opposition to any proposal for Federal taxation of the income from municipal bonds, either those to be later issued or those already issued.

2. That the city clerk be, and she hereby is, instructed to send a certified copy of this resolution to each member of the Senate and House of Representatives from Alabama, and to each member of the Senate Finance Committee and the House Ways and Means Committee.

STATE OF ALABAMA,
Jefferson County:

I, Eunice S. Hewes, city clerk of the city of Birmingham, do hereby certify that the above is a true and correct copy of a resolution duly adopted by the commission of the city of Birmingham at its meeting held February 10, 1942, and as same appears of record in minute book A-26, of said city.

Given under my hand and corporate seal of the city of Birmingham, this the 10th day of February 1942.

[SEAL] EUNICE S. HEWES, *City Clerk.*

RESOLUTION NO. 643 OF THE COUNCIL OF THE CITY OF SCHENECTADY, N. Y.

Whereas Mayor Mills Ten Eyck, of the city of Schenectady, has been informed through a communication received from the United States Conference of Mayors, dated January 28, 1942, that efforts will again be made in the present session of Congress to enact legislation subjecting municipal bonds to Federal taxation, and

Whereas at the recent annual conference of the United States Conference of Mayors a resolution was adopted on January 14, 1942, reiterating a determined opposition to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds, and

Whereas this council and the administrative officers of the city of Schenectady, N. Y., are convinced that the Federal taxation of municipal bonds will bring about an increase in the cost of all future municipal bonds, which will have to be absorbed by the imposition of additional burdens on city real estate, which is the present main source of municipal revenues, and

Whereas there is no compensating revenue for the cities, and the taxation of municipal and State bonds will tend to break down the entire constitutional theory of State and municipal sovereignty, and should the Federal Government be permitted to tax future bonds, it is likely to result in the Government's taxation of all outstanding bonds, and the possibility exists that once the Federal Government obtains such right that it may also resort in the taxation of municipal revenues: Now, therefore, be it

Resolved, That this council is in full accord with the action taken on January 14, 1942, at the annual conference of the United States Conference of Mayors, and further expresses its disapproval of any proposed legislation or attempt, in whatever form it may take, which has for its purpose the taxation of municipal bonds by the Federal Government; and be it further

Resolved, That a copy of this resolution be immediately sent to Senator Robert F. Wagner, Senator James M. Mead, Congressman Frank Crowther, the House

Ways and Means Committee, Senate Finance Committee, and Paul V. Betters, executive director of the United States Conference of Mayors.

CITY CLERK'S OFFICE, *City of Schenectady, ss:*
CITY AND COUNTY OF SCHENECTADY, *State of New York, ss:*

I, Simon Etkin, city clerk of the city of Schenectady, N. Y., do hereby certify that the resolution of which the foregoing is a true copy, was duly adopted by the Council of the City of Schenectady, N. Y., at a meeting thereof, held in the city hall in the city of Schenectady, N. Y., on the 2d day of February 1942.

Witness my hand at Schenectady, N. Y., the 5th day of February 1942.

SIMON ETKIN,
City Clerk of Schenectady, N. Y.

A RESOLUTION OF THE COUNCIL OF THE CITY OF NORFOLK, VA., REGARDING FEDERAL TAXATION OF MUNICIPAL BONDS

Whereas the Council of the City of Norfolk is advised that in all probability efforts will be directed, during the approaching session of the Congress of the United States, toward the enactment of legislation subjecting municipal bonds to Federal taxation: Now, therefore, be it

Resolved:

SECTION 1. That the Council of the City of Norfolk desires to record its strenuous and determined opposition to any proposed legislation by the Congress of the United States which seeks to subject municipal securities to Federal taxation, believing that such legislation, if enacted, would not only seriously handicap municipal finances but would tend to break down the whole constitutional theory of State and municipal sovereignty.

SEC. 2. That the city clerk be, and he is hereby, authorized and instructed to forward certified copies of this resolution to the Representatives in Congress of the State of Virginia.

Adopted by the council January 7, 1941.

A true copy.

Teste:

JNO. D. CORBELL, *City Clerk.*

A RESOLUTION BY THE CITY COUNCIL OF HOUSTON TEX., OPPOSING ATTEMPTS OF THE TREASURY DEPARTMENT TO IMPOSE A FEDERAL TAX ON STATE AND MUNICIPAL BONDS; DIRECTING THE MAYOR TO FORWARD A COPY OF THIS RESOLUTION TO THE CONGRESS, THE PRESIDENT OF THE UNITED STATES, AND THE SECRETARY OF THE TREASURY; AND DECLARING AN EMERGENCY

Whereas the United States Conference of Mayors as repeatedly and unanimously expressed its implacable opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal Governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing; Now, therefore, it is hereby

Resolved by the City Council of the City of Houston:

SECTION 1. That we hereby reiterate the determined opposition of the United States Conference of Mayors to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds; and

SEC. 2. That this most controversial domestic issue should not at this time be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and

SEC. 3. That the mayor of the city of Houston be, and he hereby is, directed to forward a copy of this resolution to the Congress, the President of the United States, and the Secretary of the Treasury.

SEC. 4. The fact that the attempt to impose a Federal tax on the income from municipal bonds will materially increase costs on municipal borrowings now contemplated by the city of Houston constitutes a public emergency requiring that this resolution be passed finally on the date of its introduction, and the mayor having in writing declared the existence of such emergency and requested such passage, this resolution shall be passed finally on the date of its introduction, this 3d day of March A. D. 1942, and shall take effect immediately upon its passage and approval by the mayor.

Passed this 3d day of March A. D. 1942.

Approved this 3d day of March A. D. 1942.

C. A. PICKETT,
Mayor of the City of Houston.

A RESOLUTION BY THE BOARD OF COMMISSIONERS OF MOBILE, ALA., PROTESTING THE EFFORT OF THE SECRETARY OF THE TREASURY OF THE UNITED STATES TO TAX THE INCOME FROM MUNICIPAL SECURITIES

Whereas it has been called to the attention of the members of this board that the Secretary of the Treasury of the United States plans to again present to the Congress and to urge the enactment of a bill which would make the income from municipal securities subject to the Federal income tax law, whether the securities be outstanding or whether they are to be issued in the future, using as a pretense the claim that the extension of the tax to include such securities is necessary for the national defense; and

Whereas from a study of the question this board is of the opinion that the extension of the tax to include the income from such securities would place the finances and the control of local self-government in the hands of the Federal Government, thereby tending to destroy one of the fundamental principles upon which our system of government was founded, and making dual sovereignty and local self-government exist only in name; and this board is further of the opinion from a study of the question that the increase in revenues gained by the Federal Government by such taxation will be offset many times over by the loss in revenues and by the inability to carry on public services by the municipalities, if such tax extension is made effective; and this board is also of the belief that such action will amount to a breach of faith with the present holders of municipal bonds and obligations; Now therefore, be it

Resolved by the Board of Commissioners of the City of Mobile, That the proposal of the Secretary of the Treasury of the United States to extend the application of the Federal income tax law to the income derived from municipal securities be, and the same hereby is, declared to be unwise, unsound, unjust, and to be destructive of the fundamental tenet of dual sovereignty and local self-government which has been one of the main bulwarks of the freedom of the individual in a Nation which has grown great largely through the freedom of the individual; and be it further

Resolved, That it is the belief of this board that control over its means of obtaining funds to carry on the functions of the government of the city of Mobile should not be tampered with or encumbered by any Federal tax which will prevent the sale of municipal securities at the best price obtainable and which will, in many instances, prevent their sale altogether by the inability to obtain legally acceptable bids; and be it further

Resolved, That the action proposed has already created a feeling of resentment on the part of municipal authorities and their organizations through unsuccessful attempts in the past to create such extension of taxation and control over municipal affairs, and it is deplored that the Treasury Department should, at this time, when a need for unified effort is paramount, create discord and confusion and use a pretense of the need for national defense to impose control from a central authority, when it is apparent that the effort to extend such Federal taxation and control was made when there was no apparent and urgent defense need; and be it further

Resolved, That the city clerk be, and he hereby is, authorized and directed to send copies of this resolution to the United States Conference of Mayors, to the National Institute of Municipal Law Officers, to each member of the House Ways and Means Committee, to each member of the Senate Finance Committee, and to each member of the Alabama delegation to Congress.

Adopted February 10, 1942.

S. H. HENDRIX, *City Clerk.*

RESOLUTION BY THE COUNCIL OF THE CITY OF SAGINAW, MICH.

Whereas the city of Saginaw, Mich., has expressed its opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds, and

Whereas in this time of grave national crisis, the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war efforts, and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue, and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatever at this time and yet would substantially increase the cost of municipal borrowing, now, therefore, it is hereby resolved,

(1) that the city of Saginaw- Mich., is hereby determined to oppose the continued attempts of the Treasury Department to impose a Federal tax on State and municipal bonds;

(2) That this controversial domestic issue should not at this time be permitted to irritate and disturb the wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and

(3) That the clerk of the city of Saginaw be, and he is hereby directed to forward a certified copy of this resolution to the United States Senators of the State of Michigan, to each Congressman from each district of the State of Michigan, to each member of the House of Representatives Ways and Means Committee, and to each member of the Finance Committee of the United States Senate.

Adopted by the following vote:

Ayes: Councilmen Boutell, Boyd, Brogger, Marxer, Symons, and Mayor Brydges.

Nays: None.

STATE OF MICHIGAN,
County of Saginaw, ss:

I, Frank B. Niederstadt, clerk of the city of Saginaw, county and State aforesaid, do hereby certify, that I have compared the annexed copy of excerpt of council proceedings of the regular meeting of the Council of the City of Saginaw held February 2, 1942, with reference to a resolution adopted by said council, with the original on file in this office, and that it is a true and correct transcript therefrom and of the whole of such original.

In witness whereof, I have hereunto set my hand and affixed the corporate seal of the city of at Saginaw, Mich., this 5th day of February 1942.

Passed February 2, 1942.

Attest:

[SEAL] FRANK B. NIEDERSTADT, *City Clerk.*

RESOLUTION BY THE COUNCIL OF THE CITY OF SAVANNAH, GA.

By the committee of the whole:

Whereas legislation is now pending in the National Congress to tax municipal bonds; and

Whereas such a tax on municipal bonds would render them less saleable and, at the same time, adversely affect the value of said bonds; and

Whereas the mayor and aldermen of the city of Savannah are opposed to such a tax on municipal bonds; and

Whereas the mayor and aldermen of the city of Savannah have issued a half million dollars of National Defense bonds and such a tax would adversely affect the sale of these bonds: Therefore, be it

Resolved by the mayor and aldermen of the city of Savannah in council assembled and it is hereby enacted by the authority aforesaid, That the mayor of the mayor and aldermen be and he is hereby authorized and directed to register the opposition of the mayor and aldermen of the city of Savannah to

such a tax proposal by communicating with the two Senators from the State of Georgia and with the Congressman of the First Congressional District of Georgia, expressing the opposition of the mayor and aldermen of the city of Savannah to such tax proposal.

I, P. J. McNamara, clerk of council, do hereby certify that the above is a true and correct copy of resolution adopted by the mayor and aldermen of the city of Savannah in council assembled, February 11, 1942.

[SEAL] P. J. MCNAMARA, *Clerk of Council.*

A RESOLUTION BY THE CITY COUNCIL OF YOUNGSTOWN, OHIO

Expressing the opposition of members of the Council of the City of Youngstown to contemplated congressional action looking to the imposition of a Federal tax on State and municipal bonds; authorizing the forwarding of copies of this resolution to various members of Congress; and providing that this resolution shall be an emergency measure

Whereas because of the unusually increased need for additional funds by the Government of the United States in the prosecution of the war and to meet the expenses incident to same, it is now, and has long been contemplated that Congress enact laws imposing a Federal tax upon State and municipal bonds for the purpose of realizing some of the needed money and to remove tax-free bonds from the markets of the country; and

Whereas the need for additional money by municipalities and States is also of prime importance and necessary in the conditions now confronting our country and its subdivisions and the markets for the sale of bonds of such subdivision; and

Whereas no apparent benefit can be pointed out as being realized through the imposition of such tax by the Federal Government upon bonds of States and municipalities other than a slight amount of revenue out of all proportions to the burden of additional cost and interest in the sale of said bonds that would be placed upon the citizens of the States and municipalities, which additional expenses to the States and municipalities would be in excess of the revenue return which might or could be secured by the Federal Government by the imposition of such tax; and further, because of the grave doubt which exists in the minds of constitutional authorities as to the constitutionality of the enactment of such law by Congress; Now, therefore, be it

Resolved by the Council of the City of Youngstown, State of Ohio, three-fourths of all its members elected thereto concurring—

SECTION 1. That we as the legislature of the city of Youngstown, duly elected to the council thereof, express herein our oppositions to the continued attempts of the Treasury Department of the United States, either by statute, administrative rulings or by judicial decree, to impose a Federal tax on State and municipal bonds for the reasons that such tax will, in the judgment of the members of this council, increase the costs covering the sale of such bonds, limit the market for same and impose an increased cost of interest charges to be able to dispose of such bonds in any bond market, which increased costs will be out of all proportions to the small return which might be able to be secured through taxation by the Federal Government, and for the reason of grave doubt as to the constitutionality of such enactment.

SEC. 2. That the clerk of council be and hereby is directed and ordered to forward copies of the above resolution to the chairman of the Ways and Means Committee of the House of Representatives, to the chairman of the Finance Committee of the United States Senate, to both Senators of the State of Ohio and to the Congressman of the Nineteenth Congressional District of the State of Ohio.

SEC. 3. That this resolution is hereby declared to be an emergency measure necessary for the immediate preservation of the public peace, welfare, and safety, the emergency being the necessity of immediately calling to the attention of the Congress of the United States the danger which would arise to States and municipalities throughout the country through the enactment of any legislation by Congress of the United States looking to the Federal taxation of municipal bonds,

and as such this resolution shall take effect and be in force immediately upon its passage and approval by the mayor.

Passed in council this 9th day of February 1942.

ARTHUR GUNDRY,
President of Council.

Attest:

JNO. H. LEMON,
Clerk.

Approved this 10th day of February 1942.

WILLIAM B. SPAGNOLA,
Mayor.

RESOLUTION BY THE CITY COUNCIL OF CHARLOTTE, N. C., CONDEMNING FEDERAL TAXATION OF MUNICIPAL BONDS

Whereas a proposal is being sponsored by certain Federal officials for the taxation of the securities of States and their subdivisions and agencies and, whereas, the Federal taxation of municipal bonds would be reflected in either an increased interest rate or a lower sale price, which would mean an increased burden upon city taxpayers and, whereas, all sources of city taxation are rapidly being curtailed except the field of ad valorem taxation of real and personal property, which are already overburdened with taxation and, whereas, the Federal taxation of local bonds would vest in the Federal authorities a means of controlling local affairs not contemplated by the Federal Constitution: Now therefore be it

Resolved, by the city council of the city of Charlotte, this 11th day of February 1942: (1) That the city of Charlotte opposes any attempt to add to the cost of State and municipal governments by the Federal taxation of the securities of States, their subdivisions and agencies.

(2) That the city of Charlotte opposes this proposal regardless of whether or not the reciprocal right is granted to States and cities to tax Federal securities because Federal securities are so scantily held within the State of North Carolina as that such reciprocal right would not produce revenue sufficient to offset the loss which the State and its subdivisions and agencies would lose by the proposal.

(3) That the city of Charlotte urges all Members of both Houses of Congress to support legislation in Congress at the 1942 session designed to prevent the taxing of outstanding bonds, or future issues, of the States, municipalities, and their instrumentalities.

(4) That the city of Charlotte endorses the objectives of the Conference on State Defense and the United States Conference of Mayors so far as same are consistent with this resolution and states its willingness to cooperate with State organizations in furthering said objectives.

(5) That a copy of this resolution be sent to all Members of both Houses of Congress from the State of North Carolina, to the members of the House Ways and Means Committee, to the members of the Senate Finance Committee, and the North Carolina League of Municipalities, and to the attorney general of the State of North Carolina.

RESOLUTION BY THE CITY COUNCIL OF LANSING, MICH.

I, Bertha Ray, clerk of the city of Lansing, Mich., do hereby certify that I have compared the annexed copy of resolution passed by the City Council of the City of Lansing on March 9, 1942, relative to taxing State and municipal bond incomes with the original now on file in my office, and that it is a correct copy thereof, and of the whole of such original.

"By Ways and Means Committee:

"Whereas the Treasury Department has again brought up the subject of Federal tax on the income from State and municipal bonds; and

"Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

"Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds, and thus needlessly resurrects this highly controversial and irritating domestic issue; and

"Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Now, therefore, be it

"*Resolved by the City Council of the City of Lansing, Mich,* That we are definitely opposed to the attempts of the Treasury Department either by statute, administrative rulings, or by judicial decree to impose a Federal tax on State and municipal bonds; and further

"That the Treasurer and Congress should keep in mind what the Supreme Court has said: 'The Power to Tax Involves the Power to Destroy'; and further

"That copies of this resolution be sent to the members of the House Ways and Means Committee and the Senate Finance Committee as per attached list and to our Michigan Senators, Hon. Prentiss M. Brown and Hon. Arthur H. Vandenberg; also Representative Blackney of this district and to Paul V. Betters, Director, the United States Conference of Mayors, 730 Jackson Place NW., Washington, D. C.

"Adopted by the following vote:

"Yeas—Aldermen Bassett, Coller, Crego, Dell, Graham, Hungerford, Letherman, LeClear, Niles, Russell, C. A. Smith, L. J. Smith, W. R. C. Smith, Snyder, Starkweather, Stoppel; 16.

"Nays—None."

Passed March 9, 1942.

In witness whereof I have hereunto set my hand and affixed the corporate seal of said city, this 13th day of March A. D. 1942.

Attest:

[SEAL] BERTHA RAY, *City Clerk.*

A RESOLUTION BY THE BOARD OF COMMISSIONERS OF WICHITA, KANS., PROTESTING THE TAXING OF MUNICIPAL SECURITIES

Whereas in the past municipal securities have been sold by the city of Wichita, Kans., at a favorable interest rate, so as to maintain a reasonably low tax levy, and low cost of municipal financing in the city of Wichita; and

Whereas according to the best opinion available a Federal tax on the interest from municipal securities would increase the interest rate thereon, by from 1½ to 2½ percent above present interest rates, which increase would necessarily have to be raised by local taxation; and

Whereas the city of Wichita, Kans., and other municipalities are already raising by local taxation, and expending large sums of money in defense activities that are essential to a successful prosecution of the war; and

Whereas the great bulk of local taxes in the city of Wichita are raised by levies on real estate, and any increase in the tax levy would place a direct burden on thousands of small home owners in the city of Wichita: Now, therefore, be it

Resolved by the Board of Commissioners of the city of Wichita, Kans., That we hereby protest the taxing of municipal securities, and hereby record our opposition to any proposal to impose a Federal tax on the interest from municipal securities; be it further

Resolved, That the city clerk be, and he is hereby, directed to forward certified copies of this resolution to members of the House Ways and Means Committee, to members of the Senate Finance Committee, and to the United States Senators from Kansas, and to the Congressman from this district.

Adopted at Wichita, Kans., this 16th day of February 1942.

JOHN I. DODSON, *Mayor.*

Attest:

[SEAL] C. C. ELLIS,
City Clerk.

STATE OF KANSAS,
Sedgwick County, City of Wichita, ss:

I, C. C. Ellis, city clerk of the city of Wichita, Kans., do hereby certify that the above resolution entitled "A Resolution by the Board of Commissioners of

Wichita, Kans., Protesting the Taxing of Municipal Securities," is a true, correct, and compared copy of the original resolution adopted by the Board of Commissioners of the City of Wichita, Kans., on February 16, 1942, and on file in this office.

Witness my hand and the seal of the city of Wichita, Kans., this 17th day of February 1942.

[SEAL]

C. C. ELLIS,
City Clerk.

RESOLUTION BY THE CITY COUNCIL OF DURHAM, N. C., RECORDING OPPOSITION TO PROPOSAL THAT INCOME FROM MUNICIPAL AND STATE BONDS BE TAXED BY FEDERAL GOVERNMENT

Whereas it has come to the attention of this council that the Congress will be requested to pass, and will consider, legislation providing for the Federal taxation of the income from State and municipal bonds; and

Whereas the proposal is not only that the income from future issues of State and municipal bonds be taxed, but also that the income from such bonds which have already been issued and sold be taxed; and

Whereas, a Federal tax on the interest from municipal bonds would greatly increase the cost of financing for the city of Durham, and it is estimated would bring about an increase of from three-fifths to 1 percent on all future municipal borrowings; and

Whereas had such a tax been in effect when the city of Durham bonds now outstanding were issued, the additional interest cost to the city of Durham as of the fiscal year which ended June 30, 1941, would have been between $15,000 and $75,000, which would represent an increase in the tax rate of this city of between 5 and 8½ cents on the $100 valuation of the total assessed property within the city of Durham; and

Whereas the city of Durham cannot levy any tax upon the interest derived from bonds issued by the Federal or State Governments; and

Whereas the bonds heretofore issued by this city were purchased upon the at least implied understanding that the income to be derived therefrom would not be subject to taxation, and the rate of interest at which the city became thereby obligated to pay upon said bonds to their maturities was accordingly made lower; and the city and its taxpayers have already received the benefits of such lower rate of interest and will continue to receive these benefits until the bonds are retired at their several maturities; and

Whereas the municipal bond market has already been upset by this proposal of the Treasury Department; and

Whereas local governments form the backbone of our democratic form of government which we are all endeavoring to protect and defend from the assaults of the Axis Nations, and a Federal tax upon the income from the bonds of States and municipalities will tend to weaken and undermine the sovereignty of local government and the principles of democracy upon which the theory of dual sovereignty rests; and

Whereas it is the considered opinion of this council that our theory of dual sovereignty be maintained, especially in these times of emergency when the governing body of this city has already been called upon and will continue to be called upon for greatly increased efforts in behalf of national defense and security; and

Whereas it is the opinion of this council that the imposition of a Federal tax on the income from State and municipal bonds cannot be justified upon the theory that such action is necessary in the interest of national defense, especially when the entire picture projected by such proposal is considered: Now, therefore be it

Resolved by the city council of the city of Durham:

SECTION 1. That this council, as the governing body of the city of Durham, is unalterably opposed to any legislation which will permit the Federal Government to tax the income from State and municipal bonds which have already been issued and those which may be issued in the future.

SEC. 2. That the city manager be, and he is hereby, directed to convey the sentiment of this council to the Congress by forwarding certified copies of this resolution to Hon. Robert L. Doughton, chairman of the House Ways and Means Committee; Hon. Walter F. George, chairman of the Senate Finance Com-

mittee; Senator Josiah W. Bailey, Senator Robert R. Reynolds, and Congressman Carl Durham, and by requesting these gentlemen to use their influence and votes against the passage of such proposed legislation.

I, C. B. Alston, city clerk of the city of Durham, do hereby certify that the foregoing is a true and correct copy of a resolution adopted by the city council in regular session held February 16, 1942.

[SEAL] C. B. ALSTON, *City Clerk.*

RESOLUTION BY THE CITY COUNCIL OF ELIZABETH, N. J.

Whereas in this time of grave national crisis the fullest cooperation between the Federal Government and municipal governments of the United States is essential to the successful prosecution of our war efforts; and

Whereas despite this grave national emergency and the need for complete unity of purpose between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrect this highly controversial issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and it would substantially increase the cost of municipal borrowing: Now, therefore, be it

Resolved by the mayor and City Council of the City of Elizabeth:

1. That we, as the duly elected representatives of the citizens of the city of Elizabeth hereby express our opposition to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decrees, to impose a Federal tax on State and municipal bonds; and

2. That the mayor of the city of Elizabeth be and he is hereby directed to forward a copy of this resolution to the Members of the United States Senate from the State of New Jersey, to the Members of the House of Representatives from this district, and to the members of the House Ways and Means Committee.

Dated: February 5, 1942.

Approved:

JAMES T. KIRK, *Mayor.*

Dated: FEBRUARY 9, 1942.

RESOLUTION BY THE CITY COUNCIL OF QUINCY, ILL.

Whereas the City Council of the City of Quincy, Ill., is advised that the Treasury Department intends to present to Congress a proposed law providing for taxation of the income of all State and municipal bonds and securities, giving as a reason therefor the need to raise money for the defense of this Nation and the prosecution of the war in which the United States of America is now engaged; and

Whereas prior to the present emergency resulting from said war, similar proposals have been defeated on grounds of legal precedent and sound governmental practice; and

Whereas the additional revenue which might be realized by such taxation would, by comparison with other sources of governmental income, be so trivial that such taxation cannot be justified as a defense measure; and

Whereas although national income would be but little augmented by such a tax, the cost of municipal government would be greatly increased because of the high rates of interest on municipal bonds and securities which would directly and immediately result from such action; and

Whereas under the operation of fundamental economic laws, the major portion of such increased costs would not be borne by the holders of municipal bonds but would be passed on to local property owners, with the result that in our case most of the increased tax burden would be placed squarely upon the shoulders of the citizens of Quincy in the form of higher personal-property and real-estate taxes and increased rentals and living expenses; and

Whereas the increased interest rates which would result from the proposed law would seriously restrict and in many cases entirely prevent needed municipal financing, thereby impairing the efficiency of local government and the service which it is able to render to the people; and

Whereas for the reasons hereinabove enumerated, such a tax would tend to cripple local self government, with a resultant trend toward complete centralization of power in Washington, contrary to the spirit of the Constitution and to sound democratic principles: Now, therefore, be it

Resolved by the City Council of the City of Quincy, Ill.:

1. That the city council does hereby declare its uncompromising opposition to any legislation which will permit a tax to be levied upon the income of state and municipal bonds and securities.

2. That it is the consensus of this council that this dangerous and widely opposed tax proposal should not at this time, and under the false cloak of patriotism and national defense, be permitted to disturb or hinder that wholehearted cooperation and unity of purpose in which Quincy and all other American cities are uniting to bring the United States of America safely and victoriously through the war.

3. That copies of this resolution be forwarded to the President of the United States, to the Secretary of the Treasury, to the Representatives of this district in the Senate and House of Representatives and to the chairmen of the appropriate congressional committees.

By order of the city council, Quincy, Ill.

FEBRUARY 9, 1942.

RESOLUTION NO. C-8413, OF THE CITY COUNCIL OF LONG BEACH, CALIF.

A resolution of the City Council of the city of Long Beach protesting against attempts of the Treasury Department of the United States of America to impose a Federal tax upon State and municipal bonds

Whereas, in this time of grave national crisis, the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and goodwill between the separate branches of our Government, the Treasury Department persists in its efforts to impose a Federal tax upon the income from State and municipal bonds and thereby needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would provide practically no revenues whatsoever at this time for the Federal Government and yet would substantially increase immediately the cost of municipal borrowing, and thereby constitute a grave crisis in the conduct of municipal activities throughout the United States,

Now, therefore, the City Council of the City of Long Beach resolves as follows:

SECTION 1. That said city council, for and on its own behalf, and on behalf of all of the citizens of the city of Long Beach, hereby protests against attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds.

SEC. 2. That this most controversial domestic issue should not at this time, under the false pretense of national defense, be permitted to irritate and disturb the wholehearted cooperation in our American war effort, which is the present objective and purpose of the cities of America.

SEC. 3. That the city clerk be and he is hereby authorized and directed to transmit, without delay, a copy of this resolution to the two California Senators and the Congressman representing the Eighteenth Congressional District, to the chairman of the House Ways and Means Committee, and the chairman of the Senate Finance Committee.

SEC. 4. The city clerk shall certify to the passage of this resolution by the City Council of the City of Long Beach, and cause the same to be posted in three conspicuous places in said city of Long Beach, and it shall thereupon take effect.

I hereby certify that the foregoing resolution was adopted by the City Council of the City of Long Beach, at its meeting of February 17, 1942, by the following vote:

Ayes: Councilmen Brunton, Clark, Klocksiem, Freeman, Fletcher, Ford, Moxley, Carroll, Gentry.

Noes: None.

Absent: None.

[SEAL] FRANK J. BEGGS, *City Clerk.*

COUNCIL RESOLUTION NO. 3764 OF THE CITY COUNCIL OF BUTTE, MONT.

A resolution declaring the policy of the city of Butte with relation to and concerning the imposition of a Federal tax on State and municipal bonds, and directing the placing of copies of this resolution with the President of the United States, the Secretary of the Treasury of the United States, and the United States Senators and Members of the House of Representatives of the United States from the State of Montana

Whereas it has come to the attention of the City Council of the City of Butte that there is in existence a proposed movement for the levy of a Federal tax upon and against future and outstanding bond issues of State and municipal bonds; and

Whereas the imposing of a Federal tax upon the income from State and municipal bonds of either existing or future issues would raise practically no revenues for the Federal Government, but would substantially increase the cost of proper and necessary municipal borrowing: Now, therefore, be it

Resolved by the City Council of the City of Butte:

SECTION 1. That it is the settled sense and policy of the city of Butte to oppose and it does hereby oppose the levying or attempting to levy, either by statute, administrative ruling, or judicial decree, the imposition of a Federal tax on State and municipal bonds.

SEC. 2. That such a proposal at this time cannot and will not do otherwise than disturb domestic tranquility and detract from the immediately present necessity for united effort of the people of the United States to single-mindedly carry on the successful prosecution of this country's war effort.

SEC. 3. That a copy of this resolution be forwarded to the President of the United States, to the Secretary of the Treasury of the United States, and to the Senators and Members of the House of Representatives in Congress from the State of Montana.

Passed this 18th day of February 1942.

Approved this 18th day of February 1942.

BARRY O'LEARY, *Mayor.*

Attest:

BERYL WILSON, *City Clerk.*

RESOLUTION BY THE BOARD OF CITY COMMISSIONERS OF FARGO, N. DAK.

Whereas the big majority of municipalities throughout the country have from time to time expressed their objection to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war efforts; and

Whereas despite this grave national emergency and the need for complete cooperation and good will between Federal, State, and municipal governments, efforts are being made to impose a Federal tax upon income from State and municipal bonds; and

Whereas the tax on issues of State and municipal bonds would raise but very little revenue and yet would substantially increase the cost of municipal borrowing: Now, therefore, be it

Resolved, by the Board of City Commissioners of the city of Fargo:

1. That we hereby express vigorous objection to the imposing of a Federal tax on State and municipal bonds.

2. That we deplore the fact that this most controversial issue should at this time, under the pretense of national defense, be again brought to the front with its consequent disturbance of wholehearted cooperation in the American war effort which is the objective of the cities of America.

3. That the auditor be and he is hereby directed to forward a copy of this resolution to North Dakota Senators and Representatives in Congress and to the chairman of the House Ways and Means Committee and the Senate Finance Committee, and respectfully request that our objections be presented to the respective committees and to the Senate and House of Representatives.

RESOLUTION OF THE CITY COUNCIL OF EAST ORANGE, N. J.

The following resolution, adopted by the city council on February 24, was approved by the mayor on February 26, 1942:

"Whereas it appears from the public press that the United States Treasury Department is advocating legislation in the Congress to impose a tax on the income from State and municipal bonds; and

"Whereas such legislation would substantially increase the cost of municipal borrowing, and such costs would have to be absorbed principally by taxes on real estate at a time when real estate is overburdened with taxes levied to meet the costs of essential municipal services, plus the cost of financing local defense: Be it

"*Resolved*, That it is the judgment of the City Council of the City of East Orange that it would be unwise for the Congress to adopt legislation to impose taxes on State and municipal bonds, and the city council does respectfully urge the United States Senators from New Jersey and the Congressmen from this district to oppose any such plan; and be it further

"*Resolved*, That a copy of this resolution be forwarded to the Hon. William H. Smathers, Hon. Albert L. Vreeland, Hon. W. Warren Barbour, and Mr. Paul V. Betters, executive director of the United States Conference of Mayors."

Attest:

ALICE I. WEBSTER, *City Clerk*.

FEBRUARY 26, 1942.

RESOLUTION BY THE COMMON COUNCIL OF THE CITY OF EAST LANSING, MICH.

Whereas it has come to the attention of the Common Council of the City of East Lansing that the Treasury Department of the United States has suggested the possibility of attempting to tax the income from municipal bonds; and

Whereas the said council feels that any such income is not subject to the taxing jurisdiction of the Federal Government, and, if imposed, would be greatly detrimental to the municipality: Now, therefore, be it

Resolved by the Common Council of the City of East Lansing, That we are opposed to the attempt of any Federal body to impose a Federal tax on municipal bonds by statute, administrative ruling, or by judicial decree; be it further

Resolved, That copies of this resolution be sent to the proper committees and representatives in Washington, D. C., of the citizens of this community.

Suported by Alderman Mitchell.

Carried.

Yeas: Barnhart, Lyman, and Mitchell.

RESOLUTION BY THE CITY COUNCIL OF CUMBERLAND, MD.

Whereas the mayor and City Council of Cumberland, Md., has repeatedly and unanimously expressed its implacable opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal Governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing; now, therefore, it is hereby

Resolved by the mayor and City Council of Cumberland, That we hereby reiterate the determined opposition of the mayor and the City Council of Cumberland to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds; and

That we express that this most controversial domestic issue should not at this time, and under the false pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and

That the finance commissioner of Cumberland be and he hereby is directed to forward a copy of this resolution to the United States Senators from Maryland, the Congresswoman of the Sixth District, and the chairman of the Ways and Means Committee of the House.

MAYOR AND CITY COUNCIL OF CUMBERLAND,
By ——— ———, *Mayor.*

Attest:
[SEAL]

S. E. G———
City Clerk.

FEBRUARY 2, 1942.

RESOLUTION BY THE BOARD OF SELECTMEN OF BROOKLINE, MASS.

On motion duly made and seconded the following resolution was adopted:

"*Resolved*, That we, the members of the Board of Selectmen of the Town of Brookline, Mass., place ourselves on record with the Senators and Congressman from this Commonwealth as being opposed to the imposition of a Federal tax upon the income from municipal bonds, and that a copy of this resolution be sent to each such Senator and Congressman and to the proper committees of Congress."

Attest:

AGNES G. KILLION, *Secretary.*

FEBRUARY 9, 1942.

RESOLUTION BY THE COMMON COUNCIL OF BUFFALO, N. Y., RE FEDERAL TAXATION OF THE INCOME FROM STATE AND MUNICIPAL BONDS

Whereas Federal taxation of the income of State and municipal bonds would impose a new burden on every municipality and would be a direct violation of the principle of State and local self-government: Therefore be it, and it is hereby

Resolved, That the common council of the city of Buffalo hereby expresses its disapproval of any intention or effort on the part of Federal authorities to exact such a tax, whether on existing or future issues; and be it further

Resolved, That a copy of this resolution duly certified by the city clerk be forwarded to each Representative from the city of Buffalo and to the United States Senators of the State of New York, and to the members of the House Ways and Means Committee and to the members of the United States Senate Finance Committee.

RESOLUTION BY THE BOARD OF COMMISSIONERS OF IRVINGTON, N. J., OPPOSING FEDERAL TAXATION OF MUNICIPAL AND STATE BONDS

Whereas certain departments of the Federal Government are preparing to introduce into the present session of the United States Congress a bill that asserts the right of the Federal Government to tax the income from municipal and State bonds; and

Whereas it is estimated that such a tax would cost the taxpayers of our State approximately several million dollars through the increased cost of municipal financing: Now, therefore, be it

Resolved by the Board of Commissioners of the Town of Irvington, county of Essex, State of New Jersey, assembled in regular session on February 10, 1942, Hereby record themselves as opposing any such legislation as set forth above respecting taxation of the income on municipal and State bonds, adopted at a regular meeting of the board of commissioners held on the above date; and be it further

Resolved, That the town clerk be and he is hereby authorized and directed to mail copies of such resolution to the Congressmen, President of the United

States, and the Secretary of the Treasury, Senators and Members of the House of the State of New Jersey.

Approved:

EDWARD D. BALENTINE,
J. EDWARD JACOBI,
PERCY A. MILLER, JR.,
HARRY E. STANLEY,
HERBERT KRUTTSCHNITT,
Board of Commissioners.

I hereby certify that the above is a true and correct copy of a resolution duly adopted at a regular meeting of the board of commissioners held on the 10th day of February 1942.

[SEAL] W. H. JAMOUNEAU, *Town Clerk.*

RESOLUTION No. 2890 BY THE COUNCIL OF THE CITY OF JOHNSTOWN, PA.

Whereas it has been brought to the attention of council that an effort will be made in the present session of Congress to enact legislation imposing a tax on outstanding, as well as future, issues of municipal bonds, and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort, and

Whereas a tax on future issues of municipal bonds would raise practically no revenue whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Now therefore be it

Resolved by the Council of the City of Johnstown, Pa., and it is hereby resolved by the authority of the same, That we hereby declare our determined opposition to the attempt of the Treasury Department, either by statute, administrative ruling or judicial decree, to impose a Federal tax on municipal bonds; and

That we express the hope that this most controversial domestic issue should not at this time, and under the false pretense of national defense, be permitted to irritate and disturb the wholehearted cooperation in our war effort which is the objective and purpose of the cities of the United States.

And further, that the city clerk is hereby authorized and directed to send a copy of this resolution to our representatives in the Congress of the United States, to Secretary of the Treasury Morganthau, and to Paul V. Betters, executive director of the United States Conference of Mayors of the United States of America.

Adopted February 3, 1942.

JOHN A. CONWAY, *Mayor.*

Attest:

JOHN J. CULLEN, *City Clerk.*

I do hereby certify that the foregoing is a true and correct copy of Resolution No. 2890 as same was adopted by council and signed by the mayor of the city of Johnstown, Pa.

[SEAL] JOHN J. CULLEN, *City Clerk.*

RESOLUTION BY THE COMMON COUNCIL OF WHITE PLAINS, N. Y., OPPOSING FEDERAL TAXATION OF MUNICIPAL BONDS

Whereas it appears that efforts are being made in the present session of the Congress to enact legislation which would permit the Federal Government to tax the income from bonds issued by municipalities; and

Whereas the United States Conference of Mayors on the 14th day of January 1942 adopted a resolution reiterating its opposition to such taxation; and

Whereas it is deemed that such taxation would impose an unfair and unwarranted increase in municipal taxes on real estate; it is, therefore

Resolved, That the Common Council of the City of White Plains does hereby concur in and does hereby approve the resolution adopted by the United States

Conference of Mayors on January 14, 1942, opposing Federal taxation of municipal bonds; and, it is further

Resolved, That the United States Senators from New York and the member of the House of Representatives from the Twenty-fifth New York District be and they hereby are requested to use all honorable methods to accomplish the defeat of any legislation which has for its purpose and intent the taxation of municipal bonds; and, it is further

Resolved, That the city clerk be and he hereby is directed to send a certified copy of this resolution to Senator Robert F. Wagner, to Senator James M. Mead, to Representative Ralph A. Gamble and to each member of the United States Senate Finance and the House of Representatives Ways and Means Committees.

STATE OF NEW YORK,
County of Westchester, City of White Plains, ss.:

I, the undersigned, city clerk of the city of White Plains, N. Y., do hereby certify that I have compared the preceding with the original resolution adopted by the Common Council of the city of White Plains, N. Y., by the affirmative vote of a majority of the members of the council at a stated meeting thereof, held the 2d day of March 1942, and I do hereby certify the same to be a correct transcript therefrom and of the whole of said original.

In witness whereof, I have hereunto set my hand and affixed the corporate seal of said the city of White Plains, N. Y., this 20th day of March 1942.

City Clerk of the City of White Plains, N. Y.

RESOLUTION BY THE COMMON COUNCIL OF EAST CHICAGO, IND.

Whereas the Treasury Department of the United States is attempting to impose a Federal tax upon income from municipal and State bonds upon the pretext of war necessities, and

Whereas such a tax upon future issues would increase the cost of municipal borrowing and would raise practically no revenue at this time; now therefore, be it

Resolved, by the Common Council of the City of East Chicago, Ind., That we are opposed to a Federal tax on municipal and State bonds however attempted; be it further

Resolved, That copies of this resolution be sent to our Senators and Congressman.

Adopted this 5th day of February, 1942.

CHARLES J. KOTZAN,
Presiding Officer.

Attest:

NORWOOD R. MARKEY,
City Clerk.

Presented by me to the mayor of the city of East Chicago, Ind., this 6th day of February 1942.

NORWOOD R. MARKEY,
City Clerk.

Approved and signed by me this 6th day of February 1942.

FRANK NUGAS, *Mayor.*

RESOLUTION NO. 2720 BY THE COUNCIL OF THE CITY OF ALAMEDA, CALIF.

Expressing city of Alameda's opposition to Federal taxation of municipal bonds.

Whereas this council is advised that the Treasury Department of the United States proposes to continue its efforts to impose a Federal tax upon the income from State and municipal bonds; and

Whereas a tax on municipal bonds would substantially increase the cost of municipal financing and would place an unnecessary and onerous burden and impediment on all future municipal borrowing; and

Whereas this city's main source of municipal revenue is derived from taxes on real estate and such increase in the cost of municipal financing would have

to be absorbed by additional burdens on real-estate taxes; Now, therefore, be it

Resolved by the Council of the City of Alameda in regular meeting assembled, That this council hereby expresses its opposition to the imposition, either by statute or by administrative ruling or by judicial decree, of a Federal tax on municipal bonds; and be it further

Resolved, That the city clerk of the city of Alameda is hereby directed to forward a certified copy of this resolution to the Secretary of the Treasury, the Senators from the State of California, the Representative in Congress of this district, to each of the Members of the United States Senate Finance Committee, and to each of the members of the Ways and Means Committee of the United States House of Representatives.

I, the undersigned, hereby certify that the foregoing resolution was duly and regularly introduced and adopted by the Council of the City of Alameda in adjourned regular meeting assembled on the 10th day of February 1942, by the following vote, to wit:

Ayes: Councilmen Brausceld, Howe, Jones, and Vice President Maurer (4).

Noes: None.

Absent: President Godfrey (1).

In witness whereof, I have hereunto set my hand and affixed the official seal of said city this 11th day of February 1942.

LOREME R. BEATIE,
City Clerk of the City of Alameda.

RESOLUTION BY THE CITY COUNCIL OF BROCKTON, MASS.

Whereas the Secretary of the Treasury has proposed taxation of future issues of city and State bonds and also to tax outstanding bonds of cities and States; and

Whereas such a measure would bring an increase of three-fifths to 1 percent on all future municipal borrowings and would have to be absorbed by additional burdens on the already overtaxed real estate of the various cities: Therefore be it

Resolved, That the mayor and City Council of the City of Brockton, Mass., does hereby go on record as opposed to any proposal to tax municipal bonds; and be it ordered

That the city clerk be directed to forward a copy of these resolutions to Senators David I. Walsh and Henry Cabot Lodge and to Congressmen Richard B. Wigglesworth and Arthur D. Healey.

In city council, February 9, 1942.

Adopted.

J. ALBERT SULLIVAN, *Clerk.*

Approved:

JOSEPH H. DOWNE, *Mayor.*

February 12, 1942.

A true copy.

Attest:

J. ALBERT SULLIVAN, *City Clerk.*

RESOLUTION BY THE CITY COMMISSION OF THE CITY OF MUSKEGON, MICH.

Whereas it has come to the attention of the City Commission of the City of Muskegon that the Secretary of the Treasury of the United States contemplates proposing a tax on State and municipal bonds; and

Whereas the City Commission of the City of Muskegon believes such tax will be detrimental to the welfare of the various States and municipalities, and various States and municipalities have heretofore protested such tax; Therefore be it

Resolved, That the City Commission of the City of Muskegon, Mich., does hereby protest the taxing of any State or municipal bonds issued or to be issued by any State or municipality;

Resolved further, That a copy of this resolution be sent to Senators Vandenberg and Brown, and Congressman Engel. Also to the executive director of the United Conference of Mayors and the National Municipal League, calling their

attention to such proposed tax and notifying them of the objection to the same.
Dated February 10, 1942.

(Signed) W. W. RICHARDS, *Commissioner.*

Supported by Commissioner Jensen.
Adopted by the following vote, viz: Ayes—Commissioners Albers, Jensen, Lundborg, Richards, and Romans. Nays—None.

STATE OF MICHIGAN,
County of Muskegon, ss:

This is to certify that the above is a true and correct copy of a resolution adopted by the City Commission of the City of Muskegon at its regular meeting held February 10, 1942, relative to a proposed tax on State and municipal bonds.
Dated this 11th day of February 1942.
[SEAL] R. F. COOPER, *City Clerk.*

RESOLUTION BY THE CITY COUNCIL OF CHEYENNE, WYO.

Entitled: "Protesting Federal legislation taxing municipal bonds either outstanding or future issues"

Whereas the United States Conference of Mayors has repeatedly and unanimously expressed its implacable opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and
Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and
Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and
Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing; Now, therefore, it is hereby
Resolved by the United States Conference of Mayors in annual conference assembled:
1. That we hereby reiterate the determined opposition of the United States Conference of Mayors to the continued attempts of the Treasury Department, either by statute, administrative rulings or by judicial decree, to impose a Federal tax on State and municipal bonds; and
2. That we express the sense of the 1942 conference that this most controversial domestic issue should not at this time, and under the false pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and
3. That the President of the United States Conference of Mayors be and he hereby is directed to forward a copy of this resolution to the Congress, the President of the United States, and the Secretary of the Treasury.
Presented, read, adopted, and passed this 16th day of February 1942.

CITY COUNCIL OF THE CITY OF CHEYENNE, WYO.,
[SEAL] By ED WARREN, *Mayor.*
Attest:

J. K. STODDARD, *City Clerk.*

THE STATE OF WYOMING,
County of Laramie, City of Cheyenne, ss:

I hereby certify the above and foregoing is a full, true, and correct copy of city of Cheyenne, Wyo., resolution No. 586, passed by unanimous vote of the city council of said city on February 16, 1942, so full and true as same appears of record in my office.
Given under my hand and the official seal of said city this 17th day of February, A. D. 1942.
[SEAL] J. K. STODDARD, *City Clerk.*

RESOLUTION BY THE CITY COUNCIL OF BURLINGTON, VT., RELATING TO FEDERAL TAXATION OF MUNICIPAL BONDS AND STATE TAXATION OF FEDERAL SECURITIES

Whereas it is the considered and unalterable conviction of the members of this council that:

1. A Federal tax on the interest from municipal securities would greatly increase the cost of municipal financing; and

2. Such increase would make the price of municipal financing so costly that many of our municipalities today would be unable to issue their securities for new and vital municipal improvements; and

3. Would result in an increase in municipal taxation and thereby impose a double burden upon local taxpayers and customers of municipally owned utilities; and

Whereas it would increase the cost of necessary refinancing of present city obligations; and

Whereas the taxation of the securities of the United States by local authorities would greatly increase the interest rates which the Federal Government would have to pay, thus bringing about a very undesirable condition in times of national emergency; and

Whereas it is, in the opinion of the members of this Council, vitally necessary that our theory of dual sovereignty be maintained especially in times of emergency when local government may be called upon for greatly increased efforts in behalf of national defense, particularly in time of war or invasion; and

Whereas it is necessary that the sovereignty and credit of the local communities be preserved; and

Whereas it is not necessary for either the local or Federal Government to impose taxes upon the securities of the other as adequate funds can be raised by other means of taxation without impairing the credit of either the local or the Federal Government; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time: Now, therefore, it is hereby

Resolved by the City Council of the City of Burlington, Vt.:

1. That we hereby record the determined opposition of this council to the continued attempts of the Treasury Department, either by statute, administrative rulings or by judicial decree, to impose a Federal tax on State and municipal bonds; and

2. That we express the conviction of this council that this most controversial domestic issue should not at this time, and under the false pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and

3. That this council hereby records its determined opposition to any proposal to impose Federal taxes upon the income from State and municipal securities or upon any function of Sate or municipal government, and its like opposition to any proposal by State or municipal governments to impose any local taxes upon the securities of the Federal Government and hereby pledges itself to join in all efforts to prevent the imposition of all such taxes.

4. That the city clerk be, and he is hereby, authorized and directed to forward a copy of this resolution to the President of the United States, the Secretary of the United States Treasury, to each of the United States Senators from Vermont, to the Representative in Congress from Vermont, and to each member of the Ways and Means Committee of the House of Representatives and each member of the Finance Committee of the United States Senate at Washington.

RESOLUTION BY THE CITY COUNCIL OF NIAGARA FALLS, N. Y.

Whereas the City Council of the City of Niagara Falls is opposed to United States Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenue whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Now, therefore, it is hereby

Resolved: 1. That the City Council of the City of Niagara Falls hereby reiterates its determined opposition to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds; and

2. That it is the feeling of this city council that this most controversial domestic issue should not at this time, and under the pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America; and

3. That the city clerk be and he hereby is directed to forward a copy of this resolution to United States Senators James Mead and Robert F. Wagner, and Representative Walter G. Andrews and the Ways and Means Committee of the House of Representatives and the Senate Finance Committee.

Witness my hand and seal this 3d day of February 1942.

[SEAL] GEO. J. RICHERT, *City Clerk.*

RESOLUTION BY THE COUNCIL OF THE CITY OF YORK, PA.

Whereas the Council of the City of York, Pa., has unanimously expressed its opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas, despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would rise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing; Now, therefore, it is hereby

Resolved by the Council of the City of York, Pa.:

1. That we are opposed to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds;

2. That the city clerk be and he is hereby directed to forward a copy of this resolution to the United States Senators Joseph A. Guffey and James J. Davis.

Passed finally, February 6, 1942, by the following vote: Yeas, 5; nays, 0.

Attest:

HARRY B. ANSTINE,
Mayor.

HENRY BUTLER,
City Clerk.

RESOLUTION BY THE COUNCIL OF THE CITY OF NEW ROCHELLE, N. Y.

Resolution opposing proposition to tax income from municipal and State bonds by the Federal Government

Whereas, by Resolution No. 89 of March 17, 1941, this council opposed a plan by the Federal Government to tax the income from municipal and State bonds; and

Whereas information has been received by this city that a similar plan is again under consideration by the Treasury Department and a committee of Congress: Now, therefore, be it

Resolved, That this council of the city of New Rochelle again expresses its opposition to any proposition to tax income of future or present bonds of municipalities as a measure which is not justified from the revenue it will produce and the hardships it will place on municipalities, as well as its inequitable distribution of the tax burden upon real estate which has in recent years been called upon to meet more and more of governmental expense not connected or commensurate with the service it has received therefrom; and be it further

Resolved, That the city clerk is hereby directed to forthwith transmit copies of this resolution to the Representatives of New York State in Congress.

Authenticated and certified this 2d day of February 1942.

STANLEY W. CHURCH,
Mayor.

CHARLES U. COMBES,
City Clerk.

RESOLUTION BY BOARD OF COMMISSIONERS OF TULSA, OKLA.

A resolution requesting the United States Congress to defeat pending legislation seeking to subject municipal bonds to Federal taxation; and declaring an emergency

Whereas legislation has again been introduced in the Congress of the United States seeking to subject municipal bonds to taxation by the United States of America; and

Whereas such proposed action by the Congress will subject all municipalities in the United States who contemplate the issuance of bonds to an added burden of taxation now pressing so heavily upon all owners of real property; and

Whereas such proposed taxation would bring about an increase of three-fifths to 1 percent on all future municipal borrowings, and would be particularly burdensome upon the city of Tulsa in its effort to advance national defense: Now, therefore, be it

Resolved by the Board of Commissioners of the City of Tulsa, Okla., as follows:

SECTION 1. That the Congress of the United States be and it is hereby respectfully requested to defeat that portion of the bill now pending before it which seeks to subject bonds of municipalities to Federal taxation, for the reasons above expressed and for the further reason that such taxation will reduce the income of municipalities from real-estate taxes at a time when such income is desperately needed by all cities.

SEC. 2. That the enactment of such taxation legislation will yield only a very small fraction of the money sought and will effectively hamstring future efforts of municipalities in the effort to finance themselves.

SEC. 3. That a copy of this resolution be forwarded to the Honorables Elmer Thomas and Josh Lee, United States Senators from Oklahoma; and to the Hon. Wesley E. Disney, Representative in Congress from the First District of Oklahoma, requesting that this resolution be brought to the attention of the members of the Ways and Means Committee of the House of Representatives and the Finance Committee of the United States Senate.

SEC. 4. That an emergency exists for the preservation of the public peace, health, safety, and finances of the city of Tulsa by reason whereof this resolution shall take effect from and after its passage and approval.

Passed, and the emergency clause ruled upon separately and unanimously approved this 3d day of February 1942.

[SEAL] C. H. VEALE, *Mayor.*

Attest:

MILTON W. DAVIS, *City Auditor.*

Approved:

J. W. GALLAHER, *City Attorney.*

RESOLUTION BY THE CITY COUNCIL OF ROCKFORD, ILL.

Resolved, That whereas the United States Conference of Mayors has repeatedly and unanimously expressed its most emphatic opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas a tax on future issues of State and municipal bonds would raise practically no substantial revenue but would bring about an increase of three-fifths to 1 percent on all future borrowings, which would increase city financing and would have to be absorbed by additional burdens on city real-estate taxes;

Resolved, That the city of Rockford supports the United States Conference of Mayors in its opposition to the continued attempts of the Treasury Department, either by statute, administration rulings, or by judicial decree to impose a Federal tax on State and municipal bonds;

Resolved, That by the adoption of this resolution the city council of the city of Rockford joins with the cities of the United States in protesting against Treasury Department proposals to impose a Federal tax on State and municipal bonds;

Resolved, That copies of this resolution be sent to the Illinois Senators, Brooks and Lucas, and Congressman Mason of this district, as well as the chairman of the Senate Finance Committee and the chairman of the House Ways and Means Committee.

FEBRUARY 2, 1942.

RESOLUTION NO. 29 BY THE COUNCIL OF THE CITY OF READING, PA.

Whereas the United States Treasury Department has for some years persistently advocated taxing, for Federal purposes, income received from State and municipal bonds; and

Whereas in a recent public address the Secretary of the Treasury, Hon. Henry Morgenthau, recommended extending the provisions of the Federal income-tax law to all presently outstanding and future issues of State and municipal bonds; and

Whereas it is the considered judgment of this body that such action on the part of the Federal Government would not only impose a hardship upon the States and municipalities but would be detrimental to the Nation as a whole: Now therefore,

The council of the city of Reading hereby resolves as follows:

That the city of Reading, Pa., in cooperation with the United States Conference of Mayors, join with her sister cities of the Nation in opposing such proposed taxation for the following reasons:

(*a*) Federal taxation of municipal bonds would bring about an increase of from three-fifths to 1 percent on all future municipal borrowings which increased cost would have to be borne by the chief source of municipal income, viz, real estate, thereby adversely affecting every holder of such property including the small home owner.

(*b*) Such proposed taxation of municipal bonds breaks down the whole theory of State and municipal sovereignty. If the Congress can tax outstanding and future bond issues by the passage of a statute, it can also tax the revenues of municipal utilities, such as waterworks, etc.

In a recent address the solicitor general of the State of New York said, "The very tax revenues of the States and municipalities themselves are income, and therefore taxable," if the proposed tax on municipal bonds can be sustained.

"The power to tax involves the power to destroy," said Chief Justice John Marshall.

(*c*) There is in the attempt of the Federal Government to impose such taxes the latent possibility of serious danger to the traditional American institution

of State and municipal home rule and the threat of a possible concentrated nationalism.

(*d*) The added cost due to increased interest rates would amount to millions of dollars more than the revenues which would be received. Be it further *Resolved* That copies of this resolution be forwarded to Senators James J. Davis and Joseph F. Guffey, Congressman Guy L. Moser, the members of the Ways and Means Committee of the United States House of Representatives, the Finance Committee of the United States Senate, and Paul V. Betters, executive director of the United States Conference of Mayors.

Passed council February 4, 1942.

HARRY F. MENGES, *Mayor.*

Attest:

DANIEL F. MCKENNA,
City Clerk.

RESOLUTION NO. 7237 BY THE COUNCIL OF THE CITY OF ROANOKE, VA.

A resolution condemning proposed legislation imposing taxes on incomes derived from State and municipal securities, and requesting Senators Carter Glass and Harry F. Byrd and Representatives Clifton A. Woodrum to oppose such proposed legislation

Whereas it appears that in spite of the fact that during the 1940 session of Congress proposed legislation to subject municipal bonds to Federal taxation was overwhelmingly defeated, a move will again be made during this session of Congress to subject to taxation incomes from future issues of State and municipal securities; and

Whereas such a Federal tax would be reflected in higher interest rates upon bonds issued by the States and their municipalities, and this increase in interest rates would result in increasing the tax burden of the citizens of the States and municipalities issuing bonds; and

Whereas such legislation would tend to make the States and their instrumentalities of government completely subordinate to the United States and thereby do violence to the fundamental concepts upon which the Federal Government was founded: Therefore be it

Resolved by the Council of the City of Roanoke, Va., That it is the sense of this body that no legislaton should be enacted by the Congress of the United States taxing incomes derived from future issues of State and municipal securities; be it further

Resolved, That this council's opposition to such legislation be made known to Senators Carter Glass and Harry F. Byrd and to Representative Clifton A. Woodrum; and they are hereby requested to vigorously oppose any bill providing for such taxation; be it further

Resolved, That the city clerk be and he is hereby directed to mail a copy hereof to said Senators and Representative.

Attest:

L. D. JAMES, *City Clerk.*

FEBRUARY 2, 1942.

RESOLUTION BY THE COUNCIL OF THE CITY OF ELMIRA, N. Y.

At a meeting of the council of the city of Elmira, N. Y., held February 2, 1942, the following resolution was adopted:

By Councilman Ellis:

"*Resolved*, That this council desires to go on record as being definitely opposed to any form of taxation on municipal bonds issued or to be issued; and be it further

"*Resolved*, That the city clerk be and hereby is directed to transmit a copy of this resolution to the United States Senators and Representatives of this district and the House Ways and Means Committee and the Senate Finance Committee."

Very truly yours,

RUSSELL F. GEE, *City Clerk*

RESOLUTION BY THE GOVERNING BODY OF THE CITY OF CLIFTON, N. J.

Whereas it has been reported that the attempt to remove the tax-exempt provisions from State, county, and municipal bonds is again reported as active; and

Whereas the passage of such legislature is deemed detrimental to the best interests of the municipalities: Now, therefore, be it

Resolved, That the governing body of this city hereby go on record as opposing any attempt to remove bonds issued by municipalities from the tax-exempt provisions which the municipalities and the people of the municipality have long had the benefits; be it further

Resolved, That a copy of this resolution be forwarded to United States Senator W. Warren Barbour, United States Senator William H. Smathers, Congressman Gordon Canfield, United States Conference of Mayors, the American Municipal Association, New Jersey State League of Municipalities, and the Conference on State Defense.

February 3, 1942.

Introduced by G. M. MEYER.

Adopted February 3, 1942.

G. M. MEYER, *Mayor.*

Attest:

[SEAL]

W. A. MILLER, *City Clerk.*

A true copy.

A RESOLUTION OF THE CITY COMMISSION OF BEAUMONT, TEX.

Whereas it has been called to the attention of the City Commission of the city of Beaumont that another effort will be made at this session of Congress to impose a tax on municipal bonds, notwithstanding the overwhelming defeat of such a measure by the last Congress; and

Whereas it is the sense and judgment of this body that such legislation will be inimical to the best interests of this city in that such legislation will greatly add to the financial burden of municipal governments throughout the country; and

Whereas the result of such legislation would be to make the interest rate on municipal bonds considerably higher and would also make the sale of such bonds more difficult; and

Whereas the rate of interest the city government would be required to pay on its bonded indebtedness would depend on the amount of taxes imposed by the Federal Government on such securities, and in view of the fact that the Supreme Court of the United States has said "the power to tax involves the power to destroy," it is plain that such legislation would make the city government dependent on the Federal Government; and

Whereas such a situation is not in accord with the principles upon which this Nation was founded—namely, that the Federal Government should be supreme in certain fields while local governments should be supreme and sovereign within their jurisdiction, and to grant to the Federal Government the power to tax the bonds and revenue of the municipal governments destroys the independence of municipal government: Now, therefore, be it

Resolved by the City Commission of the City of Beaumont, That the City Commission of the City of Beaumont go on record as being unalterably opposed to the said proposed legislation and that the sentiment of this body be made known to our Representatives in Congress to the end that we may have their continued cooperation in opposing this measure, and the city clerk be, and he is hereby, directed to mail a certified copy of this resolution to United States Senators Morris Sheppard and Tom Connally and one copy to each Member of the lower House of Congress from the State of Texas.

Passed by the affirmative vote of all members of the city commission January A. D. 1941.

GEO. MORGAN, *Mayor.*

Attest:

HUGH BLEVINS, *City Clerk.*

RESOLUTION BY THE CITY COMMISSION OF GRAND RAPIDS, MICH.

Your committee on finance recommends the adoption of the following resolution:

Whereas the Treasury Department of the United States is attempting to have a Federal tax imposed upon the income from State and municipal bonds; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing when the municipality can least stand an increased cost in municipal borrowing, as all funds are needed for national-defense work; and

Whereas in the time of this grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort and no disturbing elements should be introduced therein: Now, therefore, be it

Resolved, That the City Commission of the City of Grand Rapids does hereby reiterate its determined opposition to the attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose Federal tax on State and municipal bonds, and that copies of this resolution be forwarded by the city clerk to our Representative in Congress and in the Senate of the United States.

Adopted.

Yeas: Commissioners Borgman, Greene, Kozak, Leonard, Quinlan, Wagemaker, the mayor—7. Nays: None.

I hereby certify that the foregoing is a true transcript of the action of the City Commission of the City of Grand Rapids, Mich., in public session held February 2, 1942.

JACOB VAN WINGEN, *City Clerk.*

Copies mailed to Senators Brown and Vandenberg and Congressman Jonkman.

RESOLUTION BY THE COUNCIL OF THE CITY OF CHESTER, PA.

Whereas the Treasury Department of the United States persists in its efforts to impose a Federal tax upon the income of municipal bonds; and

Whereas a tax on municipal bonds would greatly increase the costs of all future municipal borrowing; and

Whereas an increase in the cost of municipal borrowing will greatly burden the already heavily taxed owner of real estate in the city: Therefore the council of the city of Chester does

Resolve, That the council of the city of Chester does hereby reiterate its determined opposition to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds; and

That the mayor of the city of Chester be and he is hereby directed to forward a copy of this resolution to the United States Senators representing Pennsylvania and the Member of the House from the Ninth Congressional District, and to the members of the House Ways and Means Committee and the Senate Finance Committee.

We hereby certify that this resolution passed council this 5th day of February A. D. 1942.

[SEAL] C. H. PEOPLES, *Mayor.*

Attest:

BENJAMIN NEWSOME, *City Clerk.*

I hereby certify that the above resolution was approved at a meeting of council held on February 5, 1942.

[SEAL] BENJAMIN NEWSOME, *City Clerk.*

RESOLUTION BY THE CITY COUNCIL OF THE CITY OF PEORIA, ILL.

Whereas in spite of the fact that in September, 1940, the United States Senate overwhelmingly defeated legislation subjecting municipal bonds to Fed-

eral taxation, efforts are being made in Congress to enact legislation to impose Federal taxation on municipal bonds; and

Whereas Federal taxation of municipal bonds would bring about an increase of three-fifths to 1 percent on all future municipal borrowings that would have to be absorbed by additional burdens on city real estate taxes: Therefore it is hereby

Resolved, That the city council of Peoria oppose legislation subjecting municipal bonds to Federal taxation.

I do hereby certify that the above is a true and correct copy of a resolution passed by the city council of the city of Peoria on February 3, 1942. Dated at Peoria, Ill., this 4th day of February 1942.

J. EDWARD RADLEY, *Corporation Counsel.*

RESOLUTION BY THE CITY COUNCIL OF GREEN BAY, WIS.

By the Mayor and Council of the City of Green Bay:

Resolved, That whereas the United States Conference of Mayors did at their 1942 conference pass a resolution reiterating their determined opposition to the continued attempts of the Treasury Department of the United States to impose a Federal tax on State and municipal bonds, and

Whereas in this time of grave national crisis the fullest cooperation should exist between the Federal and municipal governments in order to successfully prosecute all of our war efforts, and

Whereas it is imperative that additional burdensome taxes be imposed upon all of the citizens of the United States to successfully maintain all of our war efforts, and

Whereas these taxes have already been imposed and we are notified that further additional personal taxes will be imposed, and

Whereas despite the need for complete unity of purpose and good will between the Treasury Department and the service branches of our municipal government, the said Treasury Department persists in its efforts to impose a Federal tax upon the income from State and municipal bonds and thus does needlessly resurrect this higher controversial issue, and

Whereas under the present existing laws, the city of Green Bay and other municipal corporations have been able to dispose of their bonds at an exceedingly low rate of interest and a consequent great saving to its taxpayers, and any change in the present existing laws relative to this kind of bonds would increase the interest rate and subject the taxpayers of our city to an increased tax rate which is unfair and unjust to the taxpayers as individuals and the city of Green Bay as a municipal corporation: Now, therefore, it is hereby

Resolved by the mayor and Council of the City of Green Bay, That said council is definitely opposed to the continued attempts of the Treasury Department,

1. Either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds.

2. That this question should not at this time and under any guise be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the object and purpose of the cities of America and which would result in a loss of faith by former reliable purchasers of these bonds and disrupt and disorganize the bond market. And be it further

3. *Resolved*, That the council does exhort its honorable Senators, to wit: Hon. Robert M. La Follette, Jr.; Hon. Alexander Wiley; and also their congressional representative, the Honorable Joshua L. Johns, to use every honorable means to prevent any department of our Federal Government from in any way interfering with or disturbing the present laws relative to municipal bonds, or any move that will in any way disturb the spirit of cooperation now existing between the municipalities, the citizens, and the various departments of our Federal Government. And be it further

Resolved, That the city council be instructed to send a copy of this resolution to Senators La Follette, Wiley, and Congressman Johns.

LEO G. SCHULTZ, *Chairman of Finance Committee.*

FEBRUARY 3, 1942.

RESOLUTION BY THE COUNCIL OF THE CITY OF ST. PAUL, MINN.

Whereas from time to time there have been proposals before the Congress of the United States wherein it is sought to have Federal income taxes levied on the interest derived from municipal bonds; and

Whereas in the opinion of the Council of the City of St. Paul the adoption of such legislation would be improper, unwise and unfair and would cause an additional burden on the finances of said city; and

Whereas such tax on issues of State and municipal bonds would raise practically no revenue whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Therefore be it

Resolved by the Council of the City of St. Paul, That it hereby expresses its determined opposition to the adoption of any such legislation, and urges the Senators and Representatives in Congress from the State of Minnesota to oppose the adoption of any such legislation of that nature; be it further

Resolved, That copies of this resolution be forwarded to the Senators and Representatives from Minnesota in the Congress of the United States, and also to the Senators composing the Senate Finance Committee and to the members of the House Ways and Means Committee of Congress.

Adopted unanimously by the council February 5, 1942.

Approved February 5, 1942.

JOHN J. MCDONOUGH, *Mayor.*

RESOLUTION NO. 4808 BY THE CITY COUNCIL OF EVERETT, WASH.

Whereas the United States Conference of Mayors and the City Council of Everett, Wash. have repeatedly and unanimously expressed its implacable opposition to Treasury attempts to impose a Federal tax on the income from municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our Governmen , the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from municipal bonds and thus needlessly resurrects this highly controversial and irritating domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Now, therefore, it is hereby

Resolved by the City Council of the City of Everett, Wash.:

1. That we hereby reiterate the determined opposition of the United States Conference of Mayors to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on municipal bonds; and

2. That we express the sense of the 1942 conference that this most controversial domestic issue should not at this time, and under the false pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of the cities of America.

S. F. SPENCER,
Councilman Introducing Resolution.

Passed the city council the 2d day of February 1942.

Approved this 2d day of February 1942.

S. F. SPENCER, *Mayor.*

RESOLUTION ADOPTED BY THE COMMON COUNCIL OF THE CITY OF BRIDGEPORT, CONN.

Whereas the United States Conference of Mayors has repeatedly and unanimously expressed its implacable opposition to Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas in this time of grave national crisis the fullest cooperation between the Federal and municipal governments of the United States is essential to the successful prosecution of our war effort; and

Whereas despite this grave national emergency and the need for complete unity of purpose and good will between the separate branches of our government, the Treasury Department persists in its disturbing efforts to impose a Federal tax upon the income from State and municipal bonds and thus needlessly resurrects this highly controversial domestic issue; and

Whereas a tax on future issues of State and municipal bonds would raise only the most negligible revenues at this time and yet would substantially increase the cost of municipal borrowing, which increased costs would have to be absorbed by additional burdens on taxpayers already overburdened with added State and National taxes and increased costs of living due to the war emergency: Now, therefore, it is hereby

Resolved by the Common Council of the City of Bridgeport, Conn.:

1. That it hereby expresses the determined opposition of the Common Council of the City of Bridgeport, Conn., to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree, to impose a Federal tax on State and municipal bonds; and

2. That it expresses the sense of the said common council that this most controversial domestic issue should not at this time and under the pretense of national defense, be permitted to irritate and disturb that wholehearted cooperation in our American war effort which is the objective and purpose of Bridgeport in common with all the cities of America; and

3. That any such Federal tax on State and municipal bonds, by increasing the cost of borrowing, would throw additional financial burdens on the citizens of Bridgeport, who are already making very substantial sacrifices, both directly and indirectly, by way of added State and Federal taxes and through the mounting cost of living; and

4. That the city clerk be, and he hereby is, directed to forward a copy of this resolution to the Secretary of the Treasury, to the Senators and Congressmen from Connecticut, and to the members of the Ways and Means Committee of the United States House of Representatives and the members of the Finance Committee of the United States Senate.

Dated at Bridgeport, Conn., this 2d day of February 1942.

RESOLUTION BY THE COUNCIL OF THE CITY OF HAMTRAMCK, MICH.

Whereas in September 1940 the United States Senate overwhelmingly defeated legislation subjecting municipal bonds to Federal taxation; and

Whereas the city of Hamtramck is opposed to the Treasury attempts to impose a Federal tax on the income from State and municipal bonds; and

Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time and yet would substantially increase the cost of municipal borrowing: Now, therefore, be it

Resolved, That this Council of the City of Hamtramck does hereby go on record as being opposed to any legislation subjecting municipal bonds to Federal taxation; be it further

Resolved, That copies of this resolution be forwarded to the United States Conference of Mayors, Congress, the President of the United States, and the Secretary of the Treasury.

Supported by Councilman Banish.

Carried by the following vote: Yeas, Councilman Tenerowicz, Zajac, Banish, and Leach; nays, none; absent, Councilman Sawicki.

I hereby certify that the above and foregoing is a full, true, and complete copy of a resolution adopted by the Common Council of the City of Hamtramck at a regular meeting of said council held in the council chamber at 8521 Joseph Campau Avenue, upon Tuesday, the 3d day of February 1942, at 8 o'clock p. m.

ALBERT J. ZAK, *City Clerk.*

CITY OF MINNEAPOLIS, MINN.,
March 4, 1942.

THE UNITED STATES CONFERENCE OF MAYORS,
Washington, D. C.

GENTLEMEN: Attached you will find copy of action of the City Council of the City of Minneapolis, Minn., at a meeting held February 27, 1942, notifying

your association that the city council on March 31, 1939, memorialized Congress to defeat any legislation designed to tax public securities either by levying a tax on the income thereof, or otherwise, and reaffirming the position taken on said date.

Very truly yours,

CHAS. G. SWANSON, *City Clerk.*

Ways and Means.—Your committee recommends:

That the city clerk be directed to communicate to the League of Minnesota Municipalities, the United States Conference of Mayors, and the Conference on State Defense, the information that the city council on March 31, 1939, memorialized Congress to defeat any legislation designed to tax public securities either by levying a tax on the income thereof or otherwise, and reaffirms the position taken on said date.

Henry H. Bank, C. L. Swanson, Stanley Anderson, N. C. Irgens, Walter J. Murphy, committee.

Adopted: Yeas, 24; nays, 2, as follows:

Yeas: Aldermen Blosky, Kauth, Van Cleve, Meagher, Bank, Riley, Fruen, Christensen, Murphy, Bastis, Hendricks, Stratton, Hoppe, Carle, Pratt, Swanson, Anderson, Lund, Nelson, Irgens, Hudson, Robb, Burgum, President Wallace—24.

Nays: Aldermen Höyer, Finseth—2.

OAKLAND, CALIF., *February 11, 1942.*

Senator HIRAM W. JOHNSON,
Capitol Building, Washington, D. C.

MY DEAR SENATOR: The city of Oakland joins the United States Conference of Mayors and the Conference on State Defense in unalterable opposition to the attempts by the Treasury Department to impose a Federal tax on the income from State and and municipal bonds.

It is apparent from studies made by these two organizations, as well as the League of California Cities, that the imposition of such a tax would yield little or nothing to the Federal Government, but instead would impose a rather heavy burden upon the municipalities and other political subdivisions of the several States, would result in increased municipal taxation, and would impose a double burden upon local taxpayers.

We are firmly convinced that the imposition of such a tax will be but a stepping stone to, and will inevitably result in, taxation levied upon municipal revenues from such sources as municipally owned ports, water and light plants, etc., and will result in a break-down of the whole constitutional theory of State and municipal sovereignty upon which the federation of the United States of America has existed since the Federal Constitution was adopted.

We, therefore, respectfully urge that you use your good offices to prevent such an unwarranted encroachment upon the rights of the several States and their political subdivisions.

Very truly yours,

J. F. SLAVICH,
Mayor.
J. F. HASSLER,
City Manager.

MADISON, WIS., *March 16, 1942.*

Senator ROBERT M. LA FOLLETTE,
United States Senate, Washington, D. C.

DEAR BOB: I noticed that the proposal to tax State and local bonds will again be before the Congress. I have your letter of February 18 in which you state you have constantly favored the removal of all exemptions on income from Government bonds.

I agreed wholeheartedly that everybody, whether they were in any branch of the Government service or in private industry, should pay income taxes to the Government, but I am very much opposed to the taxation on interest derived from local bonds because I see in this tax an increase in the cost of local government.

I am a great believer in home ownership. This is inherent in my family. When my grandfather came to Madison 85 years ago, one of the first things he

did was to buy a little home in the 800 block of West Dayton Street. That property is still owned by my aunt. My father was a home owner from the time I was 5 years old. All my brothers, although they are working people with low incomes, own their little homes. Four of them are building mechanics and I am very proud of the fact that through the depths of the present depression, with construction work at its lowest ebb, at no time did they have to appeal for relief of any kind. The fact that they owned their little homes was a great help to them in maintaining such a record. I am confident that a survey would show this to be true on a Nation-wide basis. I feel home ownership and farm ownership makes a better, more loyal citizen.

The Federal Government recognizes that it is difficult for people to own their own homes by the fact that they sponsor United States Housing Authority projects. Here again the low cost is secured principally by the waving of taxes on these properties and spreading the cost of this over a period of time for those who, like my brothers, are making the effort to carry their own little homes.

I have been here almost 10 years now and I constantly see the higher levels of government gradually loading more and more upon the home owner. Feeling as I do, you can readily see how I am disappointed in this procedure. I have discussed this with your brother Phil many times. People who have studied the problem admit it is true. At a meeting in the White House in 1935 where I was present, the President admitted it was true and yet no one seems to take the trouble to do anything about it.

I simply want you to know that my letters to you on the matter of taxation are simply my effort to stop any further encroachment and I am very sorry we cannot see eye to eye on it. However, some day I am hoping that the time will come when a constructive method will be found where the low-income groups of this country will be able to own their homes without having to bear such an enormous portion of governmental expenses. There are more modern methods nowadays of taxation than the present old-fashioned ad valorem tax where everything seems to be dumped under the hit-and-miss taxation system.

As always.

Very truly yours,

JAMES R. LAW, *Mayor.*

SPRINGFIELD, MASS., *February 6, 1942.*

DEAR SENATOR WALSH: Forty years of constant contact with, and study of, municipal finances shou'd permit me to speak with some degree of authority on the subject of taxing municipal bonds.

That my knowledge of municipal borrowing is based on sound precepts may be gaged by the fact that last year I borrowed $2,000,000 at an interest rate of four one-hundredths of 1 percent. I believe this is the lowest rate obtained by any city in the United States on a comparable loan, costing just over $1 a day for a million-dollar loan.

It is with amazement that I read the statements of Secretary of the Treasury Morgenthau in a recent Cleveland speech. His proposal to tax outstanding city and State bonds leads one to ask if he has forgotten that our present national business foundation is based largely on honor and integrity. Are we to place the honor of the United States on the same scale with Germany where Hitler has made a scrap of paper of all honorable dealings? What the Secretary proposes is that we do the same thing already done by Hitler's thugs—scrap all business ethics. It makes one wonder just what we are fighting for.

I mentioned borrowing $2,000,000 at four one-hundredths of 1 percent. What would the Federal Government get by taxing such a transaction? The tax collected would not pay for the cost of collection and the funds raised would simply melt away in waste. It would, however, raise the cost to the taxpayers of the city, many hundred per cent. This case is extreme but still a real case and it would follow in lesser degree in all other municipal borrowings.

The impression given by statements that the owners of tax-exempt bonds pay no tax is absolutely false even if the statement itself is based on fact. In effect, the purchaser of municipal bonds by accepting a minimum rate of interest pays a tax at the time of purchase.

Good industrial short-term bonds now yield 2 percent and pay a tax. Comparable tax-exempt municipal bonds yield three-fourths of 1 percent. Not having to raise that 1¼ percent is just as good to the municipal government as if it paid 2 percent and raised $1.25 by taxes. There is little sense in a city paying $1.25 extra so the Federal Government can levy a tax of from 50 cents to $1

dependent on the total income of the taxpayer. We can also consider the cost of collection and leaks, always present in any taxation.

You will do well to remember that any and all taxation comes from the total public income and when taken by any one authority reduces the ability of the public to pay another agency. Any part of a tax that is wasted increases the total tax to be collected and so decreases the purchasing power of the public.

You do not need to be an expert to clearly see that this is so. Just pick up your daily paper and check the return of 6 to 10 percent on seasoned investments like American Telephone, American Can, etc. See the bonds that pay 2 to 3½ percent—sound, conservative investments. Then look at the good grade of State and municipal bonds returning ½, 1, and 1½ percent. You do not need any expert to tell you that when these municipal bonds were sold there was a tremendous saving to the taxpayers who have to raise that interest as it is paid. You do not need to be told there are no salaries of collectors, investigators, clerks, and officials and that there are no loopholes that can prevent the whole saving. You do not need to be told that when you place a tax on municipal bonds they will lose much of their appeal to the investor and he will buy only when their interest rate is high enough to pay the Federal taxes and leave a balance for him.

There is no mystery here. It is only a case of one branch of the government collecting at the expense of another branch of the government with much of the money wasted in costs by the transaction.

There are, however, other consequences of even a graver nature. It is quite certain that many of those agitating for a tax on municipal bonds know these facts to be true and continue only to form a precedent whereby the Federal Government may open an entirely new line of revenue.

Once established, this need for Federal taxes will grow and the burden coming down through the State as well as the city will come to rest on real estate that is already taxed close to the breaking point.

My reason for writing at some length is that I feel the present effort to tax municipal bonds is the most detrimental change cities have been faced with for many years and it could do irreparable harm at the very foundation of our democracy.

I hope you, too, will feel this proposal is of sufficient importance for you to exert your full influence as well as vote against the measure. A growing and vigorous opposition could put an effective stop to the continuance year after year of this short-sighted, unsound proposal which is now extremely harmful to, and, if passed, would be disastrous to, all municipal finance.

Yours very truly,

G. W. RICE, *City Treasurer.*

SPRINGFIELD, MASS., *February 5, 1942.*

HON. DAVID I. WALSH,
United States Senate, Washington, D. C.

DEAR SIR: It is my understanding that there is a strong movement to have Congress enact legislation subjecting outstanding and future municipal bond issues to Federal taxation. Inasmuch as the success of this movement constitutes a serious threat to the financial structure of local government, I desire to register a most vigorous protest against the enactment of the proposed legislation.

This proposal of the Treasury Department is not a new one, so undoubtedly you are familiar with the arguments for and against the proposal, and consequently I will not enumerate the arguments against such legislation except to state that in my opinion Federal taxation of municipal bonds will bring about seems to me that the added burden on real estate is alone a very pertinent borrowings. This increase in municipal costs would have to be absorbed by additional burdens on real estate which is the main source of municipal revenue.

There are other arguments against the suggested legislation. However, it seems to me that the added burden on real estate is alone a very important reason for opposing such legislation. I am sure you will consider the proposed legislation most carefully.

I trust that the arguments against the proposal will carry sufficient weight to cause you to oppose most vigorously the Treasury Department's effort to tax municipal bonds.

Very truly yours,

A. E. NEALE, *City Auditor.*

FITCHBURG, MASS., *February 5, 1942.*

UNITED STATES CONFERENCE OF MAYORS,
Washington, D. C.

GENTLEMEN: At a regular meeting of the city council of the city of Fitchburg, held on Tuesday, February 3, the city council of the city of Fitchburg unanimously voted that you and their Congressmen from this district be notified that they are opposed to any Federal taxation of municipal bonds, and that they will appreciate any effort on your part to oppose such Federal taxation.

Yours very truly,

EVERETT H. DUDLEY,
City Solicitor.

[Telegram]

DURHAM, N. C., *February 5, 1942.*

Hon. ROBERT L. DOUGHTON,
Chairman, House Ways and Means Committee,
Washington, D. C.:

Please strenuously oppose destructive proposal to tax State and municipal bond interest on bonds now outstanding or future issues. Treasury hiding behind defense program. Overestimating revenue from this source. Dealing morale a severe blow. Wrecking municipal financing without corresponding benefit to Federal Government. Placing burden on local governments beyond their ability to carry. Piling additional tax on overburdened real estate.

D. H. UMSTEAD,
City Auditor, Durham, N. C.

PORTLAND, MAINE, *February 12, 1942.*

Two years ago our city council unanimously adopted a resolution condemning an attempt to grant power to the Federal Government to tax the income from municipal bonds. Since the recent speech of Secretary Morgenthau advocating the Federal taxing of municipal bonds, the city council has directed me to reaffirm the opposition expressed in the resolution.

Such a power in the Federal Government does not exist under the Constitution and it would extend its control into the finances of municipalities and thereby threaten their autonomous existence. To tax outstanding municipal bond issues is dishonest. A tax on future issues is not a tax on the bond purchaser, but rather forces the municipality to pay a higher interest rate and that, in the analysis, is an additional tax on local real estate. Such an additional tax on real estate is unwarranted, as such taxes are already almost confiscatory.

If future and refunding issues only are taxed, it would take 30 years or more before they would all theoretically become taxable. The cold fact even now, however, is that Nation-wide about 85 percent of these bonds are held by trust funds, sinking funds, insurance companies, etc., where they are not subject to individual income taxes. How unreasonable it would be, therefore, to make cities pay increased interest rates on 100 percent of their future issues in order to allow the Federal Government to obtain a limited revenue on 15 percent of the total outstanding.

If municipals were taxed, the situation outlined above would be even more unfavorable to the Federal Government, as the portion held by private individuals would be sharply reduced below the 15 percent and hence the contemplated Federal revenue would become even more inconsequential. It seems to us an unwise procedure to impose upon millions of home owners an additional real-estate tax in order to drive a few rich people out of investment in municipals.

The foregoing makes one strongly suspect that the proposed tax is really a shrewdly timed move to take advantage of the war psychology to gain central financial control over all the States and cities of the country.

For the Secretary of the Treasury to urge such a dishonest policy of taxing outstanding municipal bonds is in my judgment unpatriotic, although perhaps thoughtlessly so. He is faced with the absolute necessity of selling huge amounts of Government bonds to finance the war. I knew of no action he could take that would more definitely hurt the sale of such bonds. They are nothing but a moral obligation, and if he can force the repudiation of a moral Government obligation in one case, he can do so in another. Under such circumstances, who could feel

safe in buying or urging others to buy Federal bonds? To restore confidence, the only safe policy for Congress is to unanimously vote his recommendation down and thus establish the sanctity of governmental obligations.

For the expected post-war depression, the Federal Government is already laying the foundation for the issuance of bonds by the cities for public improvements to provide employment. The proposed taxation will discourage this, and it thus furnishes a typical example of different branches of the Federal Government working at cross purposes.

We do not wish to burden you with constitutional and other prolonged and familiar arguments. Hence we merely respectfully urge that you, as a member of the Maine delegation, oppose such legislation.

Very truly yours,

JAMES E. BARLOW, *City Manager.*

KOKOMO, IND., *February 2, 1942.*

I have been informed that there has been considerable agitation on the part of Secretary Morgenthau and certain other parties to place a tax on municipal bonds, both of past and future issues. May I ask your consideration of the following points before you decide either to support or reject this proposal?

1. Federal taxation of municipal bonds would bring about an increase of three-fifths of 1 percent to 1 percent on all future municipal borrowings. This increase in municipal costs would have to be absorbed by additional burdens on city real-estate taxes, the main source of municipal revenues. One city estimates that taxing municipal bonds would cost the city $2,000,000 annually. Another states that the taxing of municipal bonds would prevent any effective refunding of its debt.

2. Even though the States may be given the privilege of taking Federal bonds, there is no compensating revenue for cities. The cities do not impose income taxes and very little of the State revenue is shared with the cities in the States where there are income taxes.

3. Taxation of municipal and State bonds breaks down the whole constitutional theory of State and municipal sovereignty. If the Federal Government can tax future bonds by passage of a "simple statute," it can tax outstanding bonds. It can also tax municipal revenues and certainly the revenues of municipal utilities such as water plants, etc. The Supreme Court has said, "The power to tax involves the power to destroy."

4. The added costs due to increased interest rates would amount to millions of dollars more than the revenues which would be received.

I cannot conceive of a condition arising in our country in which the Federal Government would add so materially to the burdens of our local government by compelling said municipalities to levy a tax to pay a tax on borrowed money. In fact, in some cities in our State, this would place the bonded indebtedness above the legal limits.

There would certainly be some very treacherous results of such legislation. Municipal bonds would be sold with more difficulty and a higher interest rate would have to be paid on said bonds.

Please give these points your very serious consideration.

Very truly yours,

H. G. FREELAND, *Mayor.*

WORCESTER, MASS., *February 2, 1942.*

With efforts apparently about to be made in the present session of Congress to enact legislation subjecting municipal bonds to Federal taxation, I wish to convey to you my belief that such legislation would be unwise.

Among the many unwholesome phases of the problem it is clear that the added costs resulting from increased interest rates would amount to millions of dollars more than the revenues which would be received.

I hope you assist in preventing any such damaging legislation.

Sincerely yours,

WILLIAM A. BENNETT, *Mayor.*

OSHKOSH, WIS., *February 2, 1942.*

Hon. FRANK B. KEEFE,
Member of Congress, Sixth District,
Washington, D. C.

HONORABLE SIR: As mayor of the city of Oshkosh I protest against any measure introduced into Congress that would be in any way increase the tax burdens of the home owner such as would be in fact true if a tax is to be imposed upon municipal bonds by certain Treasury officials.

I, therefore, take my stand with other mayors and hereby reiterate the determined opposition of the United States Conference of Mayors to the continued attempts of the Treasury Department, either by statute, administrative rulings, or by judicial decree to impose a Federal tax on State and municipal bonds.

Respectfully submitted.

GEORGE F. OAKS, *Mayor.*

POUGHKEEPSIE, N. Y., *January 30, 1942.*

Senator ROBERT F. WAGNER,
Washington, D. C.

MY DEAR SENATOR WAGNER: Secretary of the Treasury Morgenthau, in a speech at Cleveland, again brought forth the plan to propose taxing the income on municipal bonds and I believe that he went even further and advocated the taxing of the income on outstanding bonds as well as future issues.

I, as well as other municipal officials, have been of the opinion that this fight had been lost in the Senate last year but "hope springs eternal." This apparently innocuous legislation is a direct frontal attack upon the rights and sovereignties of municipalities. I feel that the issue goes far deeper than the mere dollars and cents considerations, and it is a direct encroachment by the Federal Government upon the democratic process which is to allot to the various divisions of government their own particular spheres.

It seems to me that the taxing of outstanding bonds is a direct violation of contract and its advocacy is a complete overriding of the Secretary's previous expressions on the matter.

To tax the future issues of municipal bonds is to put a terrific burden upon the small municipalities. It means undoubtedly a raise in the interest rate and you must consider that a raise in the interest rate is not something which is transitory but is something which remains frozen for the life of the issue, 20 or 30 years.

The cities are urged by the Public Works Resources Board to create a pool which might be drawn on at the cessation of the present emergency. I presume that at that time it will be necessary for the communities to raise the necessary funds by bond issues and it will be raising the funds under the proposed set-up at a premium.

I think I have stated my case as far as it applies to the city of Poughkeepsie, as well as I can possibly do, and I urge upon you the complete and unceasing opposition to this encroachment upon our democratic ideals and upon the domain of the small communities by the Federal Government.

Sincerely yours,

WILLIAM H. SCHRAUTH,
Mayor.

WILMINGTON, DEL., *February 2, 1942.*

Hon. JERE COOPER,
House Ways and Means Committee,
Washington, D. C.

DEAR MR. COOPER: We understand that efforts will be made at the present session of Congress to enact legislation subjecting municipal bonds to vital taxation.

Inasmuch as this would bring about an increase on all future municipal borrowings, and undoubtedly seriously affect municipal revenues, the city of Wilmington is opposed to such legislation.

Your favorable consideration to our position in this respect will be greatly appreciated.

Very truly yours,

ALBERT W. JAMES, *Mayor.*

DULUTH, MINN., *February 5, 1942.*

Hon. JOSEPH H. BALL,
Senate Building, Washington, D. C.

DEAR SENATOR: We, the undersigned mayor and commissioners, respectively, of the city of Duluth, Minn., respectfully beg leave to advise you that we have always been, and still are, unalterably opposed to any legislation, whether now pending or hereafter to be proposed, having for its object conferring of authority upon the United States of America to impose a tax upon the bonds of the State of Minnesota or of the city of Duluth issued in the past, or to be issued at any future date.

We expreses our opposition to any Federal legislation which will make it possible for the Federal Government to tax securities of the State of Minnesota or of the city of Duluth for the reason, among others, that such a tax cannot materially help finance the present or future program of national defense and can only result in imposing upon the State and the city of an additional burden upon already overburdened real estate within our State and city.

For the reasons above stated, and for many other reasons heretofore urged by the city council of the city of Duluth in formal resolutions adopted for such purpose, we feel that we are justified in requesting your assistance and cooperation in exerting your endeavors to defeat any form of Federal legislation which will impose a tax upon municipal securities, thereby making it difficult, if not impossible, for the city either to refund outstanding bonds or to issue new bonds when and if post-war reconstruction programs may impose the necessity upon the city to issue bonds.

Respectfully and sincerely yours,

For the city of Duluth:

E. H. HATCH,
Mayor.
E. A. BODIN,
Commissioner of Public Utilities.
F. C. DAUGHERTY,
Commissioner of Public Works.
E. W. LUND,
Commissioner of Finance.
R. F. PETERSON,
Commissioner of Public Safety.

[Telegram]

FRESNO, CALIF., *February 5, 1942.*

Hon. SHERIDAN DOWNEY,
United States Senator, Washington, D. C.

I am authorized by resolution of the commission of the city of Fresno, Calif., by the unanimous vote of its members, to urge you to unequivocally oppose legislation subjecting municipal bonds to federal taxation and particularly to oppose any taxation of outstanding city bonds. Any such taxation of outstanding city bonds would undoubtedly subject cities to suits by bondholders to recover all such taxes. You are also urged to give favorable consideration to S. 2208, second war powers act, and urge its passage as soon as possible.

Z. S. LEYMEL,
Mayor of Fresno, Calif.

WICHITA, KANS., *February 18, 1942.*

Hon. ROBERT L. DOUGHTON,
Chairman, Senate Finance Committee,
White House, Washington, D. C.

DEAR SENATOR DOUGHTON: I enclose herewith certified copy of a resolution protesting the taxing of municipal securities, which was adopted by the Board of Commissioners of the city of Wichita, Kans., on February 16, 1942.

Certified copies of this resolution are also being sent to Senators Arthur Capper and Clyde M. Reed, of Kansas; Hon. John M. Houston, of Kansas Congressional District No. 5; and to Hon. Pat Harrison, chairman of the House Ways and Means Committee.

Yours very truly,

C. C. ELLIS, *City Clerk.*

CAMDEN, N. J., *February 16, 1942.*

HON. WILLIAM H. SMATHERS,
Senate Office Building, Washington, D. C.

DEAR SENATOR: In spite of the fact that in September of 1940 the United States Senate overwhelmingly defeated legislation subjecting municipal bonds to Federal taxation, it is clear that efforts will be made in the present session of Congress to enact legislation on this subject. In view of the importance of this matter to all cities, I am again calling to your attention that the United States Conference of Mayors, assembled in session in Washington on January 12, 13, and 14, unanimously opposed Federal taxation on municipal bonds.

The whole question simmers down to the following:

1. Federal taxation of municipal bonds would bring about an increase of three-fifths to 1 percent on all future municipal borrowings. This increase in municipal costs would have to be absorbed by additional burdens on city real estate taxes—the main source of municipal revenues. The taxing of municipal bonds would prevent any effective refunding of its debt.

2. Even though the States may be given the privilege of taxing Federal bonds, there is no compensating revenue for the cities. For the cities do not impose income taxes, and, in the States where there are income taxes in effect, very little of the State revenues are shared with the cities.

3. Taxation of municipal and State bonds breaks down the whole constitutional theory of State and municipal sovereignty. If the Federal Government can tax future bonds by passage of a "simple statute," it can tax outstanding bonds. It can also tax municipal revenues, and certainly the revenue of municipal utilities such as water plants, et cetera. The Supreme Court has said: "The power to tax involves the power to destroy."

4. The added costs due to increased rates would amount to millions of dollars more than the revenue which would be received.

Therefore, I again appeal to you to use your influence in behalf of our local community, of which you are a part, by urging strongly on this matter and opposing any such legislation.

Thanking you for your cooperation, I remain,

Very truly yours,

GEORGE E. BRUNNER, *Mayor.*

CITY OF SCRANTON, PA., *February 13, 1942.*

United States Senators JOSEPH GUFFEY and JAMES DAVIS,
and Congressman PATRICK BOLAND,
Washington, D. C.

GENTLEMEN: At a meeting of council held on the above date, a motion by Mr. Druck, seconded by Mr. Rodham, was duly adopted:

That United States Senators Guffey and Davis, members of the Senate Finance Committee, and Congressman Boland, member of the House Ways and Means Committee, be notified that the Council of the City of Scranton strongly opposes any form of legislation that would subject municipal bonds to Federal taxation.

Yours very truly,

SAMUEL H. BEVAN, *City Clerk.*

CITY OF LOS ANGELES, CALIF., *February 10, 1492.*

HON. HIRAM W. JOHNSON,
The United States Senate, Washington, D. C.

MY DEAR SENATOR: This letter is being written in protest to a proposal of the Treasury Department for the enactment of legislation by the Congress to subject new issues of municipal bonds to Federal taxation, which would materially increase the coupon rate of interest on such bonds, and, in all probability, a proposal by the Treasury Department to impose a tax on outstanding city and State bonds, thereby decreasing the marketability of this class of bonds.

It has no doubt been called to your attention on numerous occasions the disastrous effect such legislation would have on municipal financing, with little or no additional revenue accruing to the Federal Treasury. While it is conceded and concurred in that every method must be utilized for the increasing of Federal revenues at this time, it must be borne in mind that municipalities, which have a very limited taxing field, are, in the final analysis, the backbone of our governmental structure and have certain fundamental functions to perform, with an

added burden necessitated by civilian defense. Municipal revenues are derived principally from taxes on real property. These same taxpayers are also the ones who are meeting, for the most part, the taxation for Federal purposes, and to place upon them an additional burden would be eminently unfair.

I sincerely trust that you will vote against such a destructive proposal.

Very truly yours,

L. V. McCARDLE, *Treasurer.*

NEWARK, N. J., *February 3, 1942.*

HON. WALTER F. GEORGE,
Chairman, Senate Finance Committee, Washington, D. C.

MY DEAR SENATOR: I am informed that there is now under consideration the passage or preparation of legislation to impose a tax upon municipal bonds.

You are undoubtedly aware that most, if not all, municipalities have opposed this type of legislation and are continuing to oppose it because of the added burden that such legislation would impose upon municipal taxpayers.

Federal taxation of municipal bonds would cause a marked increase in the cost of all future municipal borrowing. It has been roughly estimated that for Newark alone, it would result in an increase in our tax rate of as much as 100 points, or, in other words, $1 on each $100 ratables. This additional burden would undoubtedly be the straw that would break the camel's back in many of our municipalities and result in the bankruptcy of most municipalities. Federal taxation of municipal bonds would, of course, result in increased revenue to the Federal Government but would not result in any increased revenue to municipalities to overcome the additional costs entailed.

As you know, cities do not impose income taxes, and even in States where income taxes are imposed, evry little of the revenue from such taxes find their way back to the cities. It is furthermore entirely clear that the increased interest costs to municipalities would exceed, in large measure, the revenue which would be received by the Federal Government.

I feel it is unnecessary for me to point out to you the underlying constitutional dispute which has existed since the adoption of our Constitution relating to State and municipal sovereignty. While there are two schools of thought upon this subject, it is unnecessary to consider the subject in its ultimate detail because the practical effect of the taxation of municipal bonds would be so detrimental to the municipalities throughout our country as to render any discussion of the theoretical viewpoint unimportant.

May I, therefore, as mayor of the city of Newark, urgently request that you oppose any plan to tax municipal bonds?

Very truly yours,

VINCENT J. MURPHY, *Mayor.*

STOCKTON, CALIF., *February 6, 1942.*

HON. FRANK H. BUCK, M. C.,
Washington, D. C.

DEAR CONGRESSMAN BUCK: I wrote you quite sometime ago regarding the Federal Government's proposal to tax municipal bonds.

I believe you know my views on this matter. It is my recollection that you are not in accord with the same. However, be that as it may, I am still of the opinion that it would be wrong for the Congress of the United States to levy a tax on the income derived from municipal securities. To me it seems to break down the whole constitutional theory of State and municipal sovereignty. If the Federal Government can tax future bonds by the passage of a simple statute it can tax outstanding bonds, also municipal revenues derived from public utilities of various kinds.

I appreciate the fact that the United States Government must have the revenue with which to finance the war in which we are now engaged, but it is my opinion that the taxing of municipal bonds is the wrong procedure. As you know, it will greatly increase the costs of local government, which are already burdensome in many cities, for the reason that the Federal Government and the State governments have retained and taken sources of revenues which were formerly enjoyed by the cities, thereby leaving the cities' principal source of revenue the

ad valorem tax on real property and improvements. You, no doubt, as a land owner, have a keen appreciation of this fact. Will you please write me again as to your views on this matter.

I am sorry that I did not have the opportunity of seeing you when you were in California recently.

With kindest personal regards, I am,

Yours very truly,

W. B. HOGAN, *City Manager.*

CITY OF JACKSON, MISS., *February 2, 1942.*

Hon. DAN R. MCGEHEE,
Washington, D. C.

DEAR DAN: On behalf of the city of Jackson I wish to file an official protest against any legislation taxing city bonds.

The United States Conference of Mayors, of which this city is a member, has repeatedly gone on record opposing the passage of such legislation. It is proven beyond a doubt that the Federal Government will not for many years be able to collect any appreciable amount of revenue from this source of taxation.

Furthermore, if such legislation is enacted it will bring about an increase of three-fifths to 1 percent on future municipal borrowings. Such legislation as taxing municipal and State bonds, breaks down the whole system of State and municipal government.

There is already too much centralizing of governments in Washington and in the capitols of the various States. The Government should be kept closer to the people and under the control of the people through local government.

I sincerely request that you use every effort to help defeat this legislation for the above reason and the further reason that it is not a national defense necessity.

Yours very truly,

WALTER A. SCOTT, *Mayor.*

BETHLEHEM, PA., *March 10, 1942.*

Hon. CHARLES L. GERLACH,
House of Representatives, Washington, D. C.

HONORABLE SIR: City council has instructed me to write to you and request you to use your influence to defeat any proposed legislation which would subject municipal bonds to Federal taxation. We feel that the Federal taxing of municipal bonds will only increase the burden upon municipal governments for the reason that it will be reflected in the interest rate at which municipalities can issue their bonds. In many cases it would only mean that cities would have to increase their tax rate to produce the revenue to pay the tax on these bonds.

As representatives of the citizens and taxpayers of the city of Bethlehem, council is opposed to this legislation and asks that you, who also represent the citizens and taxpayers of Bethlehem as well as of other communities in Pennsylvania, also oppose any such legislation.

Very truly yours,

BERTRAM L. NAGLE, *City Clerk.*

EVANSTON, ILL., *February 10, 1942.*

Evanston City Council opposed to proposal taxing municipal bonds.

L. J. KNAPP, *City Comptroller.*

TUCSON, ARIZ., *February 5, 1942.*

Hon. Senator CARL HAYDEN,
Washington, D. C.

DEAR SENATOR HAYDEN: On my recent visit to Washington I mentioned to you, and I also had a discussion with your secretary regarding the taxing of municipal bonds by the United States Government.

As far as Tucson is concerned it would make very little difference whether municipal bonds were taxed or not because most of our outstanding bonds will

be retired in the next 3 years. I want to protest vigorously against such measures because I am firmly convinced that this procedure is fundamentally wrong. Municipal and State bonds were sold with the solemn promise and assurance of immunity from taxes and for that reason a lower rate of interest was obtained by the borrowers.

We can absolutely not afford to let these promises be just a scrap of paper, and if I have the correct information the Supreme Court of the United States has upheld immunity of the State in no less than 34 decisions extending to and including the most recent decision. These 34 cases are listed in the brief submitted to Congress by the attorneys general of the States, entitled "The Constitutional Immunity of State and Municipal Securities; A Legal Defense of the Continued Integrity of the Fiscal Powers of the State" (pp. 60-62).

Also, to quote Henry Epstein, the general solicitor for the State of New York: "Secretary of the Treasury Morgenthau has finally dropped the mask which has so far concealed the real objective of the Treasury toward the outstanding securities of the States and municipalities." He says further, "That this statement, coming as it does from the first fiscal officer of the United States Government, is not only shocking, but it probably will do more to destroy the confidence of the people of this country in the promises and good faith of their own Government than anything that I can recall to this time."

Congress should not pass this under guise of a defense measure as it strikes at the root of our governmental integrity, a principle that we cannot afford to give up without a fight to the last ditch.

All members of the council join me in asking you to defeat this measure.

Respectfully,

HENRY JAASTAD,
Mayor of Tucson, Ariz.

PASADENA, CALIF., *February 6, 1942.*

Hon. CARL HINSHAW,
New House Building, Washington, D. C.

DEAR CARL: Recent press reports indicate that the United States Treasury Department is again urging the imposition of a Federal tax upon the interest from outstanding State and local securities as well as upon future issues.

The Board of Directors of the City of Pasadena has many times enacted the opposition of the city of Pasadena to the taxation of State and municipal obligations by the Federal Government, whether such taxation be on future issues or outstanding issues, and heretofore I have written you voicing the views of the city's legislative body on this matter.

Now that the Treasury has abandoned its previous announced determination not to tax outstanding issues and is actually sponsoring such taxation under the guise of a war emergency, I am writing to again call to your attention the views of the city of Pasadena and to request that you use all your efforts to prevent the enactment of legislation which would have for its purpose the taxation of State or municipal obligations by the United States. Such taxation would increase local taxation by municipal governments, thus adding to the total tax burden of the country a great many more millions of dollars than those that will find their way to the United States Treasury.

Such taxation by the Federal Government is an initial step in a program to further expand the taxing power and break down a long-standing sovereignty of State and municipal governments, for if the Federal Government can tax obligations of local governments and the interest on such obligations, it can and no doubt will tax revenues of local governments. Thus would the constitutional safeguard against interference by the Federal Government with the State and local governments be entirely emasculated.

May I urge you, therefore, to do all possible to prevent such legislation?

Sincerely yours,

HAROLD S. HULS,
City Attorney.

NEW BEDFORD, MASS., *February 7, 1942.*

Hon. DAVID I. WALSH,
United States Senate, Washington, D. C.

DEAR SIR: I am using this means as a method of definitely asserting my opposition to the proposed legislation subjecting municipal bonds to Federal taxation.

New Bedford has been faced with serious finance problems over a period of approximately 15 years, and it is comforting to note that, at the present time, we are regaining some of our financial stability. The proposed legislation above referred to would set us back to such an extent that the future of our city would be placed in financial jeopardy.

The suggestions made in speeches by certain members of the official family in Washington has caused me great concern, and it is with this thought in mind that I am asking your concentrated effort in defeating any legislation carrying any form of municipal taxation which tends to destroy. As this matter no doubt has been brought to your attention, in previous instances, I feel certain that you are aware of its seriousness and confidently anticipate your favorable action.

Yours sincerely,

MATTHEW A. GLYNN, *Mayor.*

CHELSEA, MASS., *February 5, 1942.*

UNITED STATES CONFERENCE OF MAYORS,
Washington, D. C.

DEAR SIRS: I, Bernard L. Sullivan, mayor of the city of Chelsea, most vigorously protest the plan of Secretary of the Treasury, Mr. Morgenthau, to tax outstanding State and municipal bond issues.

In the city of Chelsea, Mass., we have outstanding approximately $2,000,000 in municipal bonds. I feel that this proposed tax would constitute a breach of trust with the investors, who rightfully anticipated that these bonds would be tax exempt. The income to be derived from this proposed tax does not warrant such unorthodox procedure.

The proposed tax levy on future municipal bond issues is not going to enhance the possibilities of borrowing needed funds in this fashion, thus resulting in an additional load being placed upon the already overburdened real-estate owners.

I, therefore, wish to be recorded and respectfully request that you likewise be recorded as very definitely opposed to this proposed tax legislation.

Yours very truly,

BERNARD L. SULLIVAN, *Mayor.*

WATERTOWN, N. Y., *February 3, 1942.*

UNITED STATES CONFERENCE OF MAYORS,
Washington, D. C.

DEAR SIRS: Our attention has been called to the fact that the Congress may consider ways and means of subjecting municipal bonds to Federal taxation. Most cities in the United States are opposed to any such action for various reasons.

Such legislation would substantially increase the cost of all future municipal borrowings and would affect refunding of such debts whenever it is necessary to do so. A decided jump in interest rates would result which would have to be absorbed by additional burdens on city real-estate taxes, the principal source of municipal revenues.

Cities are still struggling under the heavy debt load incurred during the past 12 years and should be allowed some relief from future debt service. The next few years will hardly permit most municipalities an opportunity to liquidate bonds in sufficient amount to face the next depression with any assurance of weathering the storm unaided.

If you consent to the enactment of a plan to impose a Federal tax on State and municipal bonds, it must create a very disturbing effect on such financing at a time when there should be fullest cooperation between Federal and municipal government in this grave national crisis. More aid is due municipalities at the present time rather than increased expense due to manipulations by the Federal Government of the issue in question.

Suffice it to say that the city of Watertown urges you to weigh this matter carefully and oppose the enactment of legislation which will affect the existing status of municipal bonds. A resolution covering this situation was passed by the city council, as follows:

"Whereas it has been proposed by the Secretary of the Treasury to remove immunity from Federal taxation of income from municipal bonds; and

"Whereas such proposal was defeated by the Senate of the United States by a vote of 44 to 30 on September 19, 1940, but will probably be offered in the Congress for adoption: Now, therefore be it

"Resolved by the Council of the City of Watertown, N. Y., That it is the sense of this council that removal of such tax immunity would result in great harm to municipal finances; would increase the tax burden of our municipal taxpayers, and that legislation removing this tax immunity should not be passed by Congress; and be it further

"Resolved, That the city clerk by and hereby is instructed to forward a certified copy of this resolution to the Honorable Francis D. Culkin, Representative and the Honorable Robert F. Wagner, and the Honorable James M. Mead, United States Senators for their consideration."

Thanking you for any efforts you may make in our behalf, I am

Very truly yours,

C. LELAND WOOD,
City Manager.

NEWTON, MASS., *February 3, 1942.*

Representative ALLAN T. TREADWAY,
House Ways and Means Committee,
House of Representatives, Washington, D. C.

DEAR MR. TREADWAY: From the farther end of your State, in representing the city of Newton, I ask that you use all endeavors possible to defeat any program of legislation looking toward the taxation of municipal bonds.

I have had a rather worth-while experience in municipal finance and I think I know something of the effect of such legislation upon city finances and the resulting effect of such taxation on real-estate holders in particular. I was for 3 years chairman of the emergency finance commission here in Massachusetts in 1933 to 1936, as I recall it. Under the jurisdiction of that commission came the financial situation as to all cities in the Commonwealth whose credit had been impaired by the expensive unemployment situation. We had to give O. K.'s on their borrowings. We had to study their finances in order to do so.

My experience as city solicitor of the city of Newton for over 20 years, and the experience I have just spoken of, leads me to be very much opposed to proposed legislation looking toward taxation of municipal bonds. I wish you would give my city and other Massachusetts cities your best efforts in endeavoring to defeat this proposed legislation.

Yours truly,

JOSEPH W. BARTLETT,
City Solicitor.

STAMFORD, CONN., *February 2, 1942.*

Hon. JOSEPH E. TALBOT,
Congressman, Fifth District, Connecticut,
Washington, D. C.

DEAR CONGRESSMAN: I wish to bring to your attention a matter that is vital to all municipalities throughout the country. It is the Federal taxation of State and municipal bonds.

This question has been proposed in the past and from quotations printed in the daily papers on the speech delivered by Secretary of Treasury Morgenthau in Cleveland on Saturday, January 24, it appears that the Treasury Department will again endeavor to impose such a tax on municipal and State bonds, both on future and outstanding issues.

I respectfully request that you oppose any attempt to impose a tax on these bonds. The taxation of municipal bonds would bring additional expense upon towns and cities by increasing the interest rate on bonds which would mean an added burden on all property and home owners, who, I believe you will agree, are carrying more than their share of the tax load at this time.

Enclosed herewith is a copy of a resolution on the matter passed by the United States Conference of Mayors in which this city holds membership.

Trusting you will keep a watchful eye on this matter and register your opposition at the proper time, I am

Very sincerely,

EDWARD A. GONNOUD, *Mayor.*

WORCESTER, MASS., *February 5, 1942.*

Hon. DAVID I. WALSH,
Senate Finance Committee, United States Senate,
Washington, D. C.

DEAR SENATOR: The question of taxing the income on State and municipal bonds is very disturbing to financial officers of municipalities and will cost cities such as Worcester hundreds of thousands of dollars without any adequate direct or indirect return or offset.

It will mean a definite increase in the burden to be borne particularly by owners of real estate now overburdened.

Will you please do all in your power to defeat any move that may be made to tax municipal securities already issued and also those that may be issued in the future.

Respectfully yours,

H. J. TUNISON,
Treasurer and Collector of Taxes.

JACKSONVILLE, FLA., *February 5, 1942.*

Hon. CHARLES A. ANDREWS,
Washington, D. C.

MY DEAR SENATOR: I am amazed to note Secretary Morgenthau has again suggested the taxation of future issues of city bonds.

During the emergency this city has suspended practically all improvements, has frozen funds appropriated for repairs to streets, sewers, etc., in order to conserve the amounts for national defense. I am confident the same conditions exist all over our Nation.

Furthermore, we have voted large amounts in bonds for defense purposes, we have matched Federal funds to aid the unemployed to such an extent that many improvements our citizens have a right to demand have been denied.

Jacksonville, and, I imagine, every other American city, has done these things willingly and freely, feeling that it is a real contribution to the national defense effort.

When peace comes, however, new demands are going to be made upon us which can only be met by the issuance of new bonds. We must provide work for more unemployed than we had 3 years ago, when war industries close down. We must make the municipal improvements we did without in order to aid the war effort. To tax these bonds and future issues to aid the Federal Treasury will close our last door to procuring funds to continue such functions as I have outlined.

In conclusion, I sincerely hope your good judgment will warrant your opposition to the suggestion of our honorable Secretary.

With kindest regards,

Respectfully yours,

C. W. HENDLEY, *Treasurer.*

CANTON, OHIO.

DEAR SIR: The council of the city of Canton, Ohio, at its meeting of Monday, February 2, unanimously adopted the following report which we are forwarding to you as per its provisions. We believe no further word is necessary.

"Inasmuch as there is action pending before Congress to tax municipal and State bonds, your committee on finance begs to recommend that this council go on record as very strongly protesting any taxation of any municipal and State bonds. This taxation would cripple the operation of municipalities due to the increased premium on bonds and high rate of interest required.

"It is further recommended that a copy of this report be forwarded to the chairman of the Ways and Means Committee of the House of Representatives, the chairman of the Finance Committee of the Senate, and to Senators Taft and Burton, Congressmen at Large George Bender and Stephen Young, and to William R. Thom, Representative from the sixteenth district."

Respectfully,

HAZEL SHEAFFER,
City Clerk.

QUINCY, ILL., *February 4, 1942.*

Hon. SCOTT LUCAS,
Senator from Illinois,
Washington, D. C.

DEAR SENATOR: It has been brought to my attention that the Treasury Department is again proposing to bring our municipal securities within the scope of the taxing powers of the Federal Government for the purpose of raising defense revenues. Such action would certainly seriously cripple local government and so have a tendency to swing the pendulum farther than ever toward centralized control of all local governing units by the Federal Government, which I believe is absolutely contrary to the spirit of the Constitution and to sound democratic policies.

Furthermore, there can be no question but that the added revenue which the Federal Government might raise in this way within the next few years would be trifling while the added financial burden to be placed upon municipalities would unquestionably seriously impede their functions. To advance this measure in the name of patriotism and national defense is to my mind inexcusable. Therefore, I would appreciate your every effort toward the defeat of any such proposal.

With kindest personal regards, I remain

Sincerely yours,

EDW. J. SCHNEIDMAN,
Mayor.

EVERETT, MASS., *February 2, 1942.*

Hon. DAVID I. WALSH,
Washington, D. C.

MY DEAR SENATOR: May I kindly request you to use your good office in an endeavor to stop the proposed legislation to tax the income from future and outstanding issues of municipal and State bonds.

It is my sincere belief that action to tax the income of these securities is unconstitutional; that it is a violation of the unwritten faith between our Federal, State, and municipal governments; that taxation of future issues would bring negligible income receipts at the present time; that taxation of outstanding issues is a violation between the States and the municipalities and the individuals who own their securities; and, lastly, such legislation would be equivalent to increased taxation upon the already overburdened taxpayer because such legislation would mean a definitely large increase in the interest costs of future bond issues, and larger interest costs means larger municipal tax levies, resulting in increased real-estate tax rates.

On behalf of the State of Massachusetts and the cities and towns of our State, I sincerely request that you do all possible to stop the passage of any such legislation.

Respectfully yours,

FRANK E. LEWIS, *Mayor.*

BALTIMORE, MD., *February 3, 1942.*

Hon. GEORGE L. RADCLIFFE,
Senate Office Building, Washington, D. C.

DEAR SENATOR: In pursuance of resolution adopted January 14, 1942, at the Annual Convention of the United States Conference of Mayors, I am writing in regard to proposed legislation taxing municipal bonds by the Federal Government.

I think it would be against the best interests of the city of Baltimore for the Government to place a tax on these securities.

Hope you can see your way clear to oppose passage of any law to this effect.

Yours sincerely,

HOWARD W. JACKSON, *Mayor.*

FITCHBURG, MASS., *February 2, 1942.*

Representative ARTHUR D. HEALEY,
Representative ALLEN T. TREADWAY,
Senator DAVID I. WALSH,
Senator HENRY CABOT LODGE, Jr.,
United States Senate, Washington, D. C.

DEAR SENATOR LODGE: In connection with the proposal of Secretary Morgenthau to tax municipal bonds, on the basis of all the information which I have, I cannot but record myself in opposition to any such plan.

Sincerely yours,

ALFRED WOOLLACOTT, *Mayor.*

FREMONT, NEBR., *February 13, 1942.*

Honorable Mayor and Members of the City Council, Fremont, Nebr.
Re: Taxing of income of municipal bonds.

GENTLEMEN: You have undoubtedly read in your local newspapers of proposals by Secretary Morgenthau of the Federal Treasury Department to again present to Congress a tax law calling for the taxing of the income of all municipal bonds and securities—both outstanding and future issues. To again raise these proposals at this time is to create more problems for the already overburdened municipal official, but the problem has been raised and must be met in the most effective manner possible.

The attempt to "cloak" the proposals under the labels of "national defense" and "revenues necessary for prosecution of the war" is the most unfair and misleading type of argument yet advanced to win a fight already lost on its merits by the Treasury Department when the Senate in 1940 voted down the very proposals the Secretary now proposes.

Another unfair approach to the whole problem is that used in classifying income from tax-exempt bonds as "slacker money." The burden of any tax when imposed will not fall on the bondholders but on the city issuing the bonds. When Secretary Morgenthau says his proposal would produce $200,000,000 in income taxes per year he neglects to say that these taxes will not be paid by the bondholders but by city real-estate and other taxpayers. Anyone wealthy enough to buy a city bond knows how to compute his return on the bond and he will discount the bond, or bid an interest rate, which will give him his desired return after taking into consideration all charges, costs, and taxes. True, the bondholder may serve as the person who physically hands the income tax over to the United States Treasury, but he is merely acting as a "conduit" for money coming directly from an increase in tax rates to the general city taxpayers—money earmarked for this tax purpose from the very beginning. Cities have no way to get this tax money back in their treasury on a "quid pro quo" basis by imposing a tax which will operate on Federal securities so as to equalize matters, so the money will move in just one direction—to the United States Treasury. Even in the case of outstanding bond issues most cities have promised to pay any taxes imposed on the income of those bonds.

Chaos in the market for municipal bonds and securities will be created by changing this rule of more than 150 years' standing, for the mere proposal of the Secretary has practically brought the municipal-bond market to a standstill in the last few days.

You are all familiar with the legal arguments against the Secretary's proposals but so is Congress, and the need now is for a concerted effort by cities to tear the "wartime measure" label off of these proposals so that they can be considered by the Congress on their merits. It is hard to defeat the unwise proposals of a member of the Cabinet in ordinary times and the war makes the task doubly difficult.

I suggest that you immediately make known your continued opposition to the Secretary's proposals to your Senators and Congressmen. I realize that you have probably voiced your opposition to your Senators and Congressmen in the past but suggest that you do it again to show them that the claim of "wartime necessity" has no validity. Also attached is a list of the House Ways

and Means Committee members and the Senate Finance Committee members before whom the Secretary's proposal will come, as it will be most helpful if you will transmit your views to them, also.

With kindest regards always, I remain,

Sincerely yours,

FRED H. RICHARDS, JR., *City Attorney.*

READING, PA., *March 6, 1942.*

Hon. GUY L. MOSER,
House of Representatives, Washington, D. C.

DEAR GUY: In my official capacity as city solicitor, I am writing you relative to the proposal of the present administration at Washington to impose a tax upon municipal bonds. I know that you have already been approached with appeals opposing this pernicious prospective legislation.

I know of no more forceful argument that officials of municipalities can advance against such proposed legislation than to bring forward the well-recognized complaint that the cities of the State of Pennsylvania derive almost their entire revenue from taxes levied upon real estate, thereby suggesting the problem of greater burdens to be imposed upon the overburdened owners of real estate.

Presently, in the city of Reading, there is outstanding, in the way of delinquent taxes of prior years, a half million of dollars, much of which is uncollectible. This condition imposes an added burden upon the thirfty real-estate owners of our community.

As a member of Congress, it is unnecessary to call to your attention the broad powers of Congress in the matter of levying and collecting taxes. Furthermore, I agree with the high and reverend authorities in the Nation in their sound and justifiable opposition to this proposed legislation in that it will not only greatly increase the burdens of taxation but will, at the same time, endanger such investments and greatly reduce the market value of municipal bonds on the part of many people who have, during the years of this long and brutal depression, suffered staggering losses and privations, without any near term relief.

The war will impose many additional burdens upon the cities of the Commonwealth in safeguarding its water supply and other expensive and vital governmental operations. I am sure that the citizens of Reading will appreciate your opposition to the proposed legislation.

Respectfully submitted.

JOHN P. WANNER, *City Solicitor.*

LANCASTER, PA., *February 3, 1942.*

Hon. JOSEPH F. GUFFEY,
Senate Finance Committee,
Washington, D. C.

DEAR SIR: The proposed Federal tax on new issues of municipal bonds has been of great concern to the city of Lancaster especially since the Secretary of the Treasury has suggested the inclusion of outstanding city and State bonds.

Lancaster, like most cities, has been faced with increasing difficulties in keeping a balanced budget, consistent with good government, without increased taxation and in addition thereto, our local routine and objectives have been willingly restricted in order to meet increased expenditures of civilian defense measures. Tax on municipal bonds would not only impose another tremendous burden on small political subdivisions but would defeat the vital, original, and long-standing assurance of immunity to beneficiaries through insurance, pensions, retirement, and investments.

Enclosed is a copy of Resolution No. 1029 adopted at a regular meeting of council February 3, 1942, officially opposing the tax.

We respectfully solicit your support.

Yours very truly,

CITY OF LANCASTER, PA.,
D. W. COULTER,
Director, Department of Accounts and Finance.

RESOLUTION No. 1029

Introduced by Mr. D. W. Coulter February 3, 1942. Adopted by Council February 3, 1942

Whereas it has been proposed that a Federal tax be laid upon the income from municipal bonds to be issued in the future and it is also intimated that a Federal tax be laid upon the income from exiting municipal bonds; and

Whereas such proposed Federal tax on municipal obligations would work a great hardship upon local governments and would of necessity result in increased local taxation and increased cost in future local financing; and

Whereas a proposed tax upon municipal bonds to be issued in the future would yield little or no present revenue and would, therefore, result in no material aid to the existing defense program: Now, therefore, be it

Resolved by the Council of the City of Lancaster, That the said council does hereby publicly record its emphatic opposition to the proposed levy of a Federal tax on either existing municipal bonds or municipal bonds to be issued in the future and that copies of this resolution be forwarded to the proper Members of Congress and officers of the Government of the United States of America, so that they may be apprised of the views of this council with respect to such proposed legislation.

Approved February 3, 1942.

I hereby certify that the above is a true and correct copy of Resolution No. 1029 adopted by council February 3, 1942.

[SEAL] CHARLES E. LAIRD, *City Clerk*.

The CHAIRMAN. Professor Fairchild.

STATEMENT OF FRED R. FAIRCHILD, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. FAIRCHILD. Mr. Chairman and members of the committee, the suggestions which I have to offer will deal with the question of bringing under the Federal income tax the interest upon bonds and other obligations of the States and their counties, towns, cities, school districts, and other local jurisdictions.

You have already—very proper in my opinion—rejected the proposal thus to tax the State and municipal obligations now outstanding; the present question is, I assume, limited to future issues of these obligations. With your permission, I should like, first, to set before you a brief statement of what I consider the basic economic principles determining the consequences of taxing the interest on such obligations and, second, to discuss the bearing of such action upon the position of the States in our American Federal form of Government.

On March 27 I discussed this same question before the Committee on Ways and Means of the House of Representatives. What I said at that time is, of course, now a matter of record in the printed hearings of that committee and available to the members of this committee. In presenting my suggestion to you now, I shall necessarily have to cover some of the same ground. I shall endeavor, however, not to weary you with unnecessary repetition and I shall be brief.

Analysis of the economics of this problem starts with the well-recognized principle that the forces of demand and supply in the investment market tend to produce equality in the rate of net yield

for all investments of equal risk. If one investment is burdened with a cost from which another is free, then the rate of gross yield of the first investment will tend to be enough higher than that of the second so that the rates of net yield will be the same.

It is this principle which explains the prevailing differentials between the respective rates of gross yield of state and municipal bonds and private corporation bonds of equal risk.

For example, during the 5-year period, 1937–41, we find that the average rates of gross yield of private bonds of the three top grades have been higher than those of municipal bonds of equal quality by a differential which increased from 63 points in 1937 to 103 points in 1941.

Professor Lutz has already given you the details of the statistics to which I am referring. In the year 1941, for example, the nominal rates of yield of the municipal bonds studied for this comparison averaged 1.75 percent, whereas the yield on the private bonds of equal quality average 2.78 percent, a difference of 1.03 percent.

After making due allowance for other features which might lead investors to prefer municipals over private bonds of the same rating, there can be no doubt that the differentials, as we find them, are chiefly due to the difference in taxation.

In other words, investors in 1941 were willing to take municipal bonds at a yield of 1.75 percent instead of equally sound private bonds yielding 2.78 percent because the former were exempt from Federal income tax, while the latter were taxable. The differential of 1.03 points measured the value of tax exemption.

This principle finds demonstration likewise in comparison of certain obligations of the United States Government which are exactly alike except that some are fully taxable while others are exempt. Ever since the Government began in December 1940 to issue bonds and notes whose interest is fully taxable under the Federal income tax, there has been a differential between the yield on these obligations and the yield on the corresponding tax-free obligations which can of course have no other cause than the difference in taxability.

Other witnesses preceding me have given you this picture in greater detail.

Now, in the light of these principles let us see what would happen if the law should be so changed that the interest on State and municipal obligations issued hereafter would be subject to Federal income tax.

First of all the municipalities would find that, if they were to issue their bonds at par or at the previously prevailing prices, they would have to increase the interest by about the amount of the tax.

On the basis of past experience, this would mean an increase of about 1 percent in the rate. In other words, the forces of demand and supply would see to it that purchasers of the new issues obtained, after paying taxes, a net yield equal to that of private corporation bonds of corresponding risk. If the municipalities did not provide for this by raising interest rates, the market would take care of it by corresponding decrease in the proceeds of the sale of the bonds, which would, of course, come to the same thing so far as the municipalities were concerned.

In consequence, future borrowing by the States and municipalities would bear a heavier interest charge—increased by the amount of the tax on their obligations. This increase in the cost of their financing would, so far as the borrowing were for the general purposes, have to be met by increased taxation. Such borrowing as was for the financing of public service enterprises would result either in higher charges for the public services in question or in the operation of such services at a loss, which in turn would have to be made up by more taxation.

The principal burden would fall upon the taxpayers and, in the counties, cities, towns, school districts, and other local governments this would mean chiefly an increased property tax burden. The only alternative to increased taxation would be curtailment of public functions on account of the revenue devoted to heavier interest costs.

In the next place, we have to observe that the taxation of municipal obligations to be issued hereafter would accomplish nothing by way of removing any so-called privilege enjoyed by the owners of such bonds. That argument—never in my opinion very strong—is pertinent only to the taxation of the outstanding issues.

The investors in future issues of State and municipal bonds will enjoy no privilege on account of exemption from Federal income tax. How could they have a privilege when the bonds are sold in a free market and anyone is free to subscribe for or purchase them if he cares to pay the market price? Exemption from Federal income tax will be offset by low yield, on a basis of equality with the net yield of other investments. In other words, the investor pays for his tax exemption by taking a low rate of interest. Where is the privilege?

Nor does the Government have the power, by making the interest on these future bond issues taxable, to impose a special burden on the investor. He would in consequence, merely receive a higher rate of interest or buy the bonds at a lower price, so that equality of net yield between this and other investments of similar quality would be preserved.

Finally, I remind you that taxing the interest on future issues of state and municipal bonds would make no appreciable contribution toward our present war effort. While the war is on there will obviously be little opportunity for the States and municipalities to increase their public debts by fresh borrowing. Only as bonds matured and were replaced by new issues would there be any revenues from taxing the interest. This process would be a slow one. Under normal circumstances, it would take a matter of 20 or 30 years before the present tax-free obligations were replaced by new issues whose interest was subject to the Federal income tax.

With the advent of war, however, there has been a decided curtailment in the amount of new and refunding issues. In the calendar year 1941 such issues amounted to about $1,300,000,000 but dropped to about $300,000,000 for the first 6 months of this year. The war would be over long before any substantial revenue could appear from this source.

Even if we abandon the idea of helping to finance the war and look to the ultimate effect on the public revenue, the case for taxing these

obligations is extremely weak. Let us project ourselves forward to a date when States and municipalities will have new and refunding issues (put out between now and then) equal to the present total of their debts.

Various estimates of the revenue to be obtained by the Federal Government from taxing this debt run from one hundred and fifty to two hundred million dollars. Against this we must put the burden of additional interest payments required of the States and municipalities, for the measure of which I am willing to accept Professor Lutz' estimate of $175,000,000.

Even though we allow a considerable margin of error in these estimates, it is clear, first, that the Federal revenue would be modest, and second, that the gain to the Federal Government would be largely offset by the loss to the States and their local subdivisions.

And I remind you that there is no true gain to the national economy from granting the Federal Government revenue at the expense of the State and local governments. The possible net gain from the whole operation, 20 or 30 years in the future, appears quite insignificant.

Apart from the fiscal consideration there is another line of argument which urges that taxation of the interest from State and municipal obligations is required in order to round out the structure of a logical progressive tax. It is true, of course, that investors in tax-free municipal obligations, even though on the average they pay the price in a lower rate of interest, do place this part of their incomes outside the effect of the progressive rates of the Federal income tax. I think most thoughtful students of taxation recognize this situation and would consider that our income tax would come closer to the ideal of a progressive tax if there were no classes of exempt income whatever.

As a practical matter, however, the importance of this consideration in the particular instance is apt to be greatly exaggerated. In the first place, investors in tax-free municipals do not entirely escape taxation. At the time they bought their bonds they paid for tax exemption according to what the market estimated it was worth.

It is true, of course, that the price was the same to all investors and that there is therefore no allowance for different degrees of wealth. But by and large the tax freedom of the whole group of investors is counteracted by the lower rate of interest.

In the second place, it is not true, as is often asserted, that the wealthy taxpayers have rushed en masse into purchase of tax-free municipals. The argument here proves too much.

If there be such tremendous advantage as is claimed, one wonders why men of wealth don't put practically all of their funds into tax-free municipals. The Treasury submitted to the Ways and Means Committee a record of studies which have been made of the distribution of the investments of decedents' estates, from which it appears that, while there are individual cases of heavy investment in tax-free municipalities, there is by and large no extreme concentration in the tax-free bonds even on the part of the larger estates. Investment in State and municipal bonds appears on the average not necessarily greater than might be dictated by sound investment judgment.

And finally, it should be recalled that the taxation of State and municipal bond interest would result in higher interest costs and an increase in State and local taxes.

Now, our State taxes, are in the main more or less regressive in character, and this regressive feature is even more pronounced in the local taxes, about 90 percent of which are property taxes. Assuming that the purpose of the Federal taxation of State and municipal bond interest is to strengthen the progressive character of our tax system, what is the gain, if, while making the Federal income tax slightly more progressive, we have increased the burden upon the people of the relatively regressive taxes of the States and the local governments?

The case for taxing the interest on State and municipal obligations thus seems to have little strength. On the other hand, there are positive considerations in opposition which to me appear powerful and predominant. And in laying these considerations before you I hope you will permit me to follow rather closely the language of my statement before the Committee on Ways and Means.

We have here in the United States of America a Federal form of Government. Its adaptability to our circumstances and its outstanding advantages to us are, I believe, so clear and so generally recognized that I do not need to stress them here. In such a political structure, sovereignty has necessarily to be divided between two grades of government, the national Government on the one side and the constituent States on the other.

This inevitably involves pressures and conflicting claims and the maintenance of a balance. The conditions of such conflict and balance are subject to change. In the formative days of our Nation, the advantage of position in this conflict was definitely on the side of the States. It was only with great difficulty and after a long struggle that the national Government was endowed with sufficient powers, especially in the field of taxation and finance, to establish it as a sovereign Government. In the century and a half that followed, there has been more or less continuous conflict between our two grades of government, and there have been frequent changes to meet changed conditions.

Gradually the advantage of position has shifted from the States to the Federal Government. I think it is safe to say that most current forces are tending toward concentration of power in the Federal Government and corresponding loss of power by the States.

This movement has progressed so far that, in my belief, the continued sovereignty of our States is in real danger.

At no point is sovereignty more vulnerable than where its financial powers are threatened. During the American Revolution the Continental Congress set a pitiful example of incompetence, chiefly because of the lack of essential financial power.

The same deficiency was mainly responsible for the collapse of the National Government under the Articles of Confederation. The lesson of our early experience as a people was that there can be no real sovereignty without adequate financial power. Today the greatest danger to the sovereignty of our States is in the attack upon their financial integrity.

It is from this viewpoint that I would approach the problem of the tax-free State and municipal bonds. It has been shown that to subject the interest on these bonds to the Federal income tax would place a heavy burden upon our States and their subordinate jurisdic-

tions. This is a real burden, capable of measurement. The States and municipalities would be compelled to raise their tax rates. They would be restricted and hampered in the performance of their sovereign functions.

If, in consequence, they should be forced to call upon the Federal Government for further financial aid, the threat to their sovereignty would be so much the more ominous.

Nor is it only these direct burdens of taxation that are to be feared. Federal power to tax would imply power also to classify the State and municipal obligations, to exempt some and tax others, to tax different issues at different rates.

It would imply power to dictate the terms of the loan contracts and to inspect and regulate their issue, thus interfering in State and local borrowing and other fiscal policies. Any government whose financial policies and operations are subject to or threatened by espionage and interference such as this has lost something of its character as a sovereign State.

And having gone this far, would we not have made smooth the path toward further encroachment? Might we not next face the proposal to tax the income from municipal public-service enterprises, such as the water system? Thereafter it would not be so long a step to seek power to tax the revenues from fees, assessments, and finally taxes. Such powers might naturally be accompanied by requirement of detailed reports, scrutiny of management, dictation of accounting terms and methods, veto of costs, and other such controls, all of which are today becoming familiar enough to the owners and managers of private business. We had better pause before stepping over this threshold.

As in my statement before the Ways and Means Committee, I am not now basing my plea on technical questions of constitutionality.

Nor, do I think the problem is solved by asserting that withdrawal of tax exemption would simply put the State and municipal bonds on a par with other similar investments. I am rather basing my case on common sense and hard facts.

Denial in future of the existing exemption from Federal income tax would inquestionably place a heavy burden upon our States and their subdivisions. It would further weaken their position, already impaired by many other recent tendencies. Here is matter for our serious consideration as we face what may be a real struggle to preserve the sovereign existence of our States and maintain our time-honored Federal form of Government.

The CHAIRMAN. Thank you very much, Professor.

Senator DANAHER. Question please.

The CHAIRMAN. Yes, Senator Danaher.

Senator DANAHER. Professor Fairchild, I have heard it urged that if the States and municipalities had to compete in the capital market without the disparity which is alleged to be in their favor now, they would be compelled to restrict the services that municipalities and States are compelled to render and therefore the cost of government would be that much less, consequently, it would not be so easy for the city fathers and planners to fund their debt and therefor to borrow.

Do you choose to comment on that argument?

Mr. FAIRCHILD. Well, Senator, I have heard that argument many times. I think the simple answer is if we are to have a sovereign government in our States, if our municipalities are to be permitted to govern their affairs under the constitutions and statutes of the different States, that is a question for the city authorities to determine. I do not admit that it is a function of the Federal Government, by withdrawing a freedom from Federal taxation which has always been enjoyed, to seek to curb the expenditures of our municipalities, even though we might think, from an altruistic point of view, that it might be well for some of our municipalities to reduce their expenditures. That, after all, is their decision, so long as we maintain a constitutional distinction between the sovereign powers of our National Government and those of the State.

Senator DANAHER. And, in the long run, is it not true that the people of a given community get just about the kind of government they are willing to stand for anyhow?

Mr. FAIRCHILD. I think they do, and I think, if we, in our wisdom, think it is not as good as they ought to enjoy, we have got to put the question up to them. After all, they are the ones to decide.

Senator DANAHER. There is another argument that reaches me from time to time and that is by making it easy for municipalities and local communities to borrow, that they compete with industry to the point where industry has to pay a very great deal more for its money and therefore, it retards the healthy growth of business in this country.

Do you think there is anything to that?

Mr. FAIRCHILD. I think that, in the main, is answered by the operation of the forces of demand and supply in the investment market. The municipalities do have the advantage, but from the investors' point of view, there is no advantage after you have made full allowance for equal risk. The figures that have been given by other witnesses, and by myself, verify I think, the basic economic principle which I stated that, given the equality of risk, the final net yield of different investments will be the same. Let me add that there does not appear anything to indicate that our municipalities are lying on any bed of roses financially.

I think the record will show that no injury has been done to American industry by the preservation of this constitutional prohibition of Federal taxation of interest on State and municipal obligations.

After all, the investors who are choosing between private industrial bonds and State and municipal bonds will be governed by a great variety of motives and considerations and they finally must make their choice.

I do not think any undue burden has been placed upon our industry in competition with the securities offered by the States and municipalities.

Senator DANAHER. Thank you very much.

The CHAIRMAN. Thank you very much, Professor Fairchild.

At this point the committee has been favored with a statement by Mr. Northcutt Ely, special counsel, on behalf of the Department of Water and Power of the City of Los Angeles, Calif., which will go into the record.

(The brief referred to is as follows:)

BRIEF OF NORTHCUTT ELY, SPECIAL COUNSEL, ON BEHALF OF THE DEPARTMENT OF WATER AND POWER OF THE CITY OF LOS ANGELES

I am directed by the Los Angeles Department of Water and Power to submit to you the attached resolution of the city council opposing the taxation of income derived from municipal bonds. I am also asked to invite your attention to the effect of such taxation upon the cost of financing borne by the department of water and power.

The department of water and power is a department of the city of Los Angeles, existing by virtue of the freeholders' charter of the city. The affairs of the department are conducted under the direction of a citizens' board of five members. The department operates the waterworks and the electric works serving the city's inhabitants.

REVENUE BONDS OF DEPARTMENT OF WATER AND POWER SINCE 1935

Since 1935 the department of water and power has issued revenue bonds, payable solely from the revenues of the department, aggregating approximately $165,000,000, not including approximately $28,000,000 of borrowings from the Reconstruction Finance Corporation, which likewise are payable solely out of the revenues of the department.

VOLUME OF REVENUE BONDS OUTSTANDING

For the last 6 months of 1941 the department had outstanding an average of approximately $100,000,000 of the revenue bonds referred to in the preceding paragraph. The interest cost on these bonds for that 6-month period was a total of $1,652,000, or at the rate of approximately 3.3 percent per annum. These bonds were issued on the opinion of bond counsel, as well as the city attorney of Los Angeles, that interest on them is exempt from taxation by the United States of America, under the Constitution of the United States as now in force, and that such interest is exempt from taxation under the existing laws of the State of California.

EFFECT OF TAXATION ON INTEREST COSTS TO DEPARTMENT OF WATER AND POWER

If a like amount of these bonds had been issued, subject to Federal income taxation, it is estimated that the interest cost would have been about 1 percent higher, in which case the department's charges for interest for the last 6 months of 1941 would have been approximately $500,000 greater than they actually were, or at the rate of $1,000,000 increased interest costs per year.

FUTURE FINANCING

With respect to any future financing of the department, the same relative increased interest cost would be encountered if the tax-exemption feature were absent. The department faces the necessity for very large increases in borrowings to finance expansions of its generating system to meet very large war loads which have confronted us, and, after the war, to meet a backlog of extensions, improvements, and betterments which must be deferred for the duration of the war because of shortages of materials.

GENERAL OBLIGATION BONDS

In addition to the revenue bonds summarized above, the department carries the debt service on certain general obligation bonds of the city. For the last 6 months of 1941 the Department had outstanding an average of approximately $83,000,000 of such general obligation bonds. The interest cost on these bonds for such 6-month period was $1,808,000, or at the rate of approximately 4.35 percent per annum. Assuming the same increase in interest cost of 1 percent, the department's charges for interest on such bonds for the last 6 months of 1941 would have been approximately $415,000 greater than they actually were, or at the rate of approximately $830,000 increased interest cost per year. The aggre-

gate annual cost to the city involved in the difference between tax-exempt and taxable bonds, measured against financing of the present magnitude, is thus estimated at a figure in excess of $1,800,000.

The general obligation bonds, like the revenue bonds, were issued under the opinion of counsel that they were tax-exempt.

CONCLUSION

It is understood that this committee does not propose to consider legislation having a retroactive effect. Aside from that, however, in view of the large financing task now confronting us, particularly in connection with expansion necessitated by war requirements, the department is equally concerned with regard to the threat of legislation which entails higher interest costs on this new financing, occasioned by a withdrawal of the tax-exempt feature.

The figure of 1-percent increase in interests costs attributed to removal of the tax-exempt feature is based on advice from investment bankers and brokers. While opinion may differ as to the actual spread involved, it is possible that some of this difference of opinion may arise from the fact that the market may have already discounted to some extent the threat of removal of the tax exemption, so that the present cost of money includes in part an increase in costs already accomplished by the market's fear of such legislation. One percent, we are advised, probably represents a fair valuation of the difference between the interest rates available if the shadow of this legislation were removed, and the rates required if the proposed legislation should become fully effective.

As we understand it, the fundamental questions as to the constitutionality and equities involved in the proposed legislation are being fully covered by other witnesses, and consequently this statement is restricted to a factual presentation of the results as they affect the city of Los Angeles and its department of water and power.

RESOLUTION OF THE COUNCIL OF THE CITY OF LOS ANGELES

Whereas the United States Senate Finance Committee is to meet on August 3, 1942, to consider the question of whether or not the Federal Government shall tax the revenue on future issues of municipal bonds: now, therefore, be it

Resolved, That the City Council of the City of Los Angeles, in cooperation with the mayor of said city, does hereby express its unqualified opposition to the Federal Government taxing the income from municipal bonds, either past or future, on the grounds heretofore presented by the States and cities and the Conference on State Defense, and for the following additional reasons: The war emergency has placed greater burdens upon this city in that it is required to expend its tax income in greater amounts because of the necessity of providing additional public services, to wit, traffic control and regulations; greater sewer requirements; health services; additional police efforts; additional fire protection; establishing and maintaining civilian defense and providing facilities for State defense; assumed tort liability in connection with civilian defense in event of invasion or air raids; assumed employee compensation liability for air-raid wardens, auxiliary police, and fire wardens.

Los Angeles is peculiarly located on the Pacific coast in the heart of the war defense industries. These burdens arise by reason of a large concentration of troops in this area and large increase in civilian population engaged in war industries, and by reason of the fact that, because of its geographical location and the concentration of war industry factories and shipbuilding, there is greater danger of enemy air raids than in other areas. These burdens now assumed, and to be assumed, because of the aforesaid matters, have the effect of diminishing its taxing capacity for usual and necessary public constructions and functions for years to come. Additional burden is also placed upon this city because of the extensive Federal and civilian war operations which are now tax-exempt under the provisions of the Reconstruction Finance Corporation Act, as amended June 10, 1941; that instead of proposing to tax the income from municipal bonds, the Federal Government should grant to this city, and to other cities, in proportion to their burdens, subventions to compensate for additional expenditures required by the war emergency; be it further

Resolved, That the city clerk certify to the adoption of this resolution and transmit copies thereof to the Honorable Walter F. George, chairman of the

Finance Committee of the Senate of the United States, and to the Honorable Hiram W. Johnson and to the Honorable Sheridan Downey, Members of the United States Senate from California.

I hereby certify that the foregoing resolution was adopted by the Council of the City of Los Angeles at its meeting held July 31, 1942.

[SEAL] WALTER C. PETERSON, *City Clerk.*
By J. E. HOPPER, *Deputy.*

The CHAIRMAN. The committee will recess until 2 o'clock, at which time we will resume the hearings on this question that we had under consideration this morning.

(Whereupon, at the hour of 12:47 p. m., the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

(Whereupon, at 2 p. m., the committee met pursuant to recess.)

The CHAIRMAN. The committee will come to order, please.

Who is the next witness?

Mr. TOBIN. Senator, may I file a communication from the National Education Association which they asked me to submit for the record of the committee? It is about two pages.

The CHAIRMAN. You may do so; yes, sir. That is relating to this same subject?

Mr. TOBIN. Same issue.

(The document submitted by Mr. Tobin is as follows:)

NATIONAL EDUCATION ASSOCIATION OF THE UNITED STATES,
Washington, D. C., July 31, 1942.

Senator WALTER F. GEORGE,
Chairman Finance Committee, United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: In behalf of the National Education Association, representing more than 200,000 educators throughout the Nation, I wish to express opposition to the United States Treasury Department's proposal for taxing the income from State and local government (including school district) bonds under the Federal Revenue Act. I understand from newspaper reports that your committee has decided to reject this proposal so far as it applies to bond issues already outstanding. The National Education Association commends this decision. We feel that the Federal Government has a moral obligation to refrain from taxing bonds issued as tax exempt by the smaller governmental units. Aside from the ethical aspects, however, we believe that there are equally compelling reasons why the interest on future issues of State and local bonds should not be taxed.

The National Education Association opposes Federal taxation of the income from State and local bonds on two main grounds:

1. It would increase the cost of borrowing by State and local governments at a time when other costs of these governments are already rising and when their revenue outlook is uncertain.

2. It would represent an unjustifiable interference by the Federal Government in the financial affairs of the States and municipalities.

In hearings before the Ways and Means Committee of the United States House of Representatives, Mr. Randolph Paul estimated that the spread between present interest rates on State and municipal tax-exempt securities and the rates which would have to be paid on such securities after the elimination of the present tax exemption would be from one-fourth to one-half percent. While estimates from other usually reliable sources have placed this increase in interest rates somewhat higher, it should be noted that a rise to only 3½ percent of the interest rate on a 3-percent bond would increase the cost of financing that bond by about 17 percent. Such increased costs could only be met by higher tax rates levied on the rank and file of State and local taxpayers—taxpayers who will also be called upon to carry the burden of heavily increased Federal taxation.

This increased cost of financing Government borrowing would come at a time when all other Government costs are likewise rising and when the revenue outlook for States and municipalities is, to say the least, uncertain. A recent poll of municipal finance officers disclosed that many of them were facing prospects of lower revenues from local taxes in the next 2 years. Estimates by State revenue officials of the decrease in gasoline-tax collections during the 1943 fiscal year range from 25 to 50 percent. Should the failure of State and municipal revenues become general, the Federal Government might find it necessary to aid in the financing of State and local public services. This would more than offset any income to the Federal Treasury gained through the taxation of securities now exempt.

The National Education Association realizes that winning the war is, and should be, the prime objective of all units of government. It believes that State and local governments should cheerfully accept the burden of the added services which they are required to perform in connection with the war and should cooperate with the Federal program in every essential particular, but it also believes that the Federal Government has a responsibility for the protection of its political subdivisions from unnecessary interference in the performance of their normal functions.

The National Education Association looks upon the proposal to remove the tax exemption from State and municipal bonds as one more unwarranted step in the tightening of Federal control over State and local fiscal operations and the centralization of financial power at Washington. The very fact that some degree of trend in this direction is unavoidable in view of the war emergency makes it all the more important to safeguard the authority of State and local governments from any unnecessary encroachment.

I understand that the Treasury Department's stated reason for favoring Federal taxation of State and municipal bonds is that it would eliminate the possibility of income tax avoidance by wealthy individuals. I am informed however, that a very large proportion of these bonds is held, not by individual investors, but by insurance companies, foundations, and semipublic agencies—types of organizations which may be said to render a public service.

I am glad to have the opportunity of stating the views of this association since we have a vital interest in the financing of public services. We believe that the proposal to tax State and local bond issues is unnecessary and dangerous.

Very cordially yours,

WILLARD E. GIVENS,
Executive Secretary.

Mr. TOBIN. May I also file the statement of the American Bar Association, at their request?

The CHAIRMAN. Yes; you may file that.

(The document above referred to is as follows:)

STATEMENT OF MURRAY SEASONGOOD, OF CINCINNATI, REPRESENTING THE AMERICAN BAR ASSOCIATION

As a former chairman of the municipal law section of the American Bar Association, a member for some years of the house of delegates of that association, and at the request of the president of the American Bar Association, I am appearing to call to your attention and speak in support of the following resolution of its house of delegates adopted March 17, 1941:

"*Resolved*, That if the existing immunity from taxation by the Federal Government now applying to public securities issued by a State, a local subdivision, or local authority thereof is to be abolished, either as to interest or principal, in the opinion of this association, the question of such abolition should be first submitted to the several States for the approval of a properly drawn amendment to the Constitution of the United States to accomplish that purpose."

This resolution was first presented by a committee of the section on municipal law to that section. It was accompanied by a careful and elaborate report in support of the resolution. The resolution was approved by the section and ordered submitted to the house of delegates. It was unanimously approved by the house of delegates. The control and administration of the association is,

by article V, section 1, of the constitution of the American Bar Association, vested in the house of delegates representative of the profession of the law in the United States. Its membership (Const. V, 3) consists of State and local bar association delegates and others so that it is thoroughly representative of the views of the American bar.

The bar association is most concerned with the effect of the proposed taxation on the structure of our Government and how we should effect changes in that structure.

This issue is profound. It is not a choice between conflicting social policies. Basically, it involves the question whether you should further subordinate the States to the Federal Government, whether you should continue the trend toward centralization and away from local self-government, or should you call a halt and restore the States and cities to the place in the Federal framework which apparently was intended when the tenth amendment was adopted in the Bill of Rights, reserving to the States all powers not delegated to the United States.

That issue, it seems to the American Bar Association, should be submitted to the people of the United States and to the States themselves, as the Constitution itself requires in the clause with regard to amendments.

The witnesses who have appeared here for the several States and cities have revealed the dangers of this proposal to the financial structures of local governments. They have shown that the proposal involves not only an increase in the cost of local government, but, in the recent language of the Supreme Court, that it would involve "Vital considerations * * * respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit" (*James* v. *Dravo Contracting Co.*, 302 U. S. 134 (1937)). This direct interference with the States' ability to borrow is what distinguishes a tax on securities of States and municipalities or the interest thereon from the indirect tax on salaries of State and local officers. The latter is permissible. The former is not (*Helvering* v. *Gerhardt*, 304 U. S. 405 (1938)).

From my experience as former mayor of Cincinnati, I can confirm the predictions which have been made here as to the serious effect of this tax on local financing. From reputable local bond houses I have ascertained that the decline in the market value of Cincinnati bonds, following Secretary Morgenthau's recent speech in Cleveland, in which the Treasury Department favored the taxation of municipal bonds, is about three-quarters percent in income yield. In future issues for the years to come such diminution would amount to a very substantial sum and would, no doubt, force the city to curtail some necessary improvements. The additional cost of financing projected to the present bonded debt of the city would amount to about $550,000 in addition per annum. With the shrinkage of city real estate values, the increased taxes necessary for borrowing would present a serious problem. Competent local bond houses have estimated that bond interest on future Cincinnati issues, if the bonds were subject to Federal income tax, would have to be raised in a city like Cincinnati, whose credit is excellent, something over 1 percent. In cities whose credit is not so good, the increase might be as much as 3 percent, with the result that some such cities could not issue and market bonds at all.

But the objections, serious as they are, vanish if the matter is submitted to the people and to the States in a properly drawn amendment. If the people want to amend the Constitution to permit this dislocation of powers, then by all means let them do so. In that way we will avoid the dangers inherent in the assertion of supreme Federal power to tax the functions of the States. Rather, the States will have surrendered a privilege of their own volition.

Furthermore, if the Federal Government receives the power to impose this tax by a constitutional amendment, there cannot be those disturbing claims to Federal supremacy which have been the basis of the Treasury's arguments in favor of the validity of the tax. No one will then be able to claim that the Federal Government possesses the power, asserted by the Treasury, to tax the actual revenues of State agencies, by a distorted interpretation of the words "from whatever source derived" in the sixteenth amendment. And a properly drawn amendment could protect against the dangers of Federal control over local policies.

The argument against granting this power over the States by means of a constitutional amendment has been that it is low, cumbersome, and uncertain. Yet, this proposal has been advocated by the Treasury for the last 4 years. Is there much greater speed, gentleman, in the Treasury's advocacy of the statutory

procedure? Could not the issue have been decided long ago, if the Treasury had asked Congress to refer the matter to the States and people for a true expression of their desires? But, perhaps, that is what they meant when they say that the mehod of amendment is "uncertain." Apparently, they feel that there is no certainty that the amendment would be adopted. But how strange that is in a democracy. If the States and the people do not desire to grant this power to the Federal Government, what reason is there to continue to urge its enactment in a short and simple statute.

And if it is speed that the Treasury wants, they certainly are on the wrong track by urging a statute of doubtful constitutionality in place of a straightforward resolution proposing a constitutional amendment for ratification by the States. For all practical purposes, such a statute could not be enforced until the Supreme Court decided it to be constitutional. And the history of these constitutional litigations shows them to have taken years before final decision. The case which allowed the States and the Federal Government to tax the salaries of each other's employees was in the courts for about 5 years. On the other hand, the last three amendments to the Constitution of the United States were adopted in an average time of about 18 months. It seems, gentleman, that if the American people really want to change the form of their Government, they manage to do it by a constitutional amendment in a reasonable time. And in the process they strengthen true federalism and the maintenance of our dual system of government.

Mr. TOBIN. As I suggested, Senator, before, most of the remainder of the witnesses would like the privilege of submitting their statements for the record.

Mayor Green of Birmingham would like to submit a statement on behalf of his city, which he thinks would be sufficient if he simply submits it for the record.

The CHAIRMAN. Is the Mayor here?

Mr. TOBIN. Is Mayor Green of Birmingham here?

(No response.)

Mr. TOBIN. He is not back just now.

The CHAIRMAN. He wishes to submit a statement?

Mr. TOBIN. Yes, sir.

The CHAIRMAN. He may do so.

Mr. TOBIN. And then we could conclude, Senator.

Mr. Chatters had a statement he wished to make. He could submit that for the record, except that he would like to present orally about 3 or 4 minutes of it.

The CHAIRMAN. He is the next witness?

Mr. TOBIN. Yes, sir.

STATEMENT OF CARL H. CHATTERS, CHICAGO, ILL., EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA

Mr. CHATTERS. There is only one point in the testimony that I would like to speak to briefly, and that is the question that was raised this morning about the effect on post-war finances should the income from State and municipal bonds be taxed.

I am basing that on the studies which I have mentioned in the statement I am submitting. The burden of the story is this: That during a period of several years many of the bonds of the States and localities as well were issued at a rate which approached the maximum at which bonds could be sold. That is to say a very great number of them were sold at rates of 5¾ percent or more.

Now, if the bonds were taxed, the rates would naturally be greater, substantially 1 percent less in some cases; more in others.

Now, following the last war and during the last depression period, cities faced two things: in some cases they were unable to sell their bonds at all, and in other cases they would have been unable to sell them had the interest rate been greater.

Now, in the last depression the cities tried to help come out of the depression by post-war public works. Now, if we tax the bonds, we are going to raise the rates to such an extent that, based on their experience of the depression period, they would not be able to sell those bonds. So if the bonds are taxed, you are going to make it more difficult for the cities to participate in a post-war program of public works.

My own city of Flint, Mich., where I was director of finance for a great many years, had, during the period of 1919 to 1920, to sell bonds of 6's. We sold several millions of 6's. During the depression the city there could not sell bonds at all. During 1 year there were as many as a thousand communities that sold bonds just below the maximum level, and if those bonds had been taxed, they could not sell them.

What I am saying is this: that if we make those bonds taxable, you are, at the same time, making it much more difficult, if not impossible, for some of the States, and a great majority of municipalities, particularly the small municipalities, to bear their own burden on public works and, therefore, there will be a tendency again to call on the Federal Government for an unusual amount of Federal assistance, and you are going to do that at the time when the Government will not be in a position to give it. When the war is over it should conserve its finances as far as it could.

When you have to issue bonds for post-war public works if you tax the future issues you are making it difficult for the cities to finance themselves, and, therefore, forcing them into the lap of the local government for financing post-war public works.

During the last period of depression, that is, 1931, 1932, and 1933, several of the States, the States themselves, issued bonds that were just below the maximum level.

Going back further to 1919 and 1920, there were at least 12 of the States in 1 year that sold bonds at 6 percent or just below it.

Now, those rates may not happen again, but all we have to go by is past experience, and both the States and the localities in very large numbers—in 1 year the localities to the extent of more than a thousand, sold bonds at just below the maximum rate at which it is generally conceded they can sell bonds, and should we tax the bonds and make the rates higher, it is going to be very difficult for them to participate in a post-war program.

Not only that, but at the present time, as you mentioned this morning, you are asking the cities in many cases to make unusual expenditures for public works. You say they can't do any, but at the same time, some of them have to for the war effort.

You take the city of Norfolk, which has recently issued two million in bonds to expand their industries, and, therefore, their municipal services and their municipal facilities, you are making it difficult for

them to do that, and they will have to pay the future penalty. That is substantially all I care to say at this time.

I have made extensive studies of all of the bond sales for several years, trying to develop the information on which those simple statements are made, and it seems to me that if for no other reason we ought not to tax the bonds at this time, simply in order that the States and cities may fully cooperate in a program of public works, and that they may do the financing instead of having to call on the Federal Government to do it.

Senator GUFFEY. What years did those bonds sell at 6 percent?

Mr. CHATTERS. A great many in 1919, 1920, and 1921. I can give you the specific States if you would like to have them.

Senator GUFFEY. I wanted to know what years they were.

Mr. CHATTERS. In 1920 there were five States: Massachusetts, Georgia, New Mexico, South Dakota, and Utah.

In 1921, there were 12 States: Arkansas, California, Florida, Georgia, Michigan, Nevada, New Mexico, North Carolina, North Dakota, Oregon, South Dakota, and Washington.

It is rather surprising to hear that the States themselves did sell bonds at a 6-percent rate, but it goes to show that even the States can be affeced by the change in rates.

The CHAIRMAN. Any other questions?

(No response.)

The CHAIRMAN. Thank you very much.

You wish your formal statement to go into the record?

Mr. CHATTERS. Yes; I would prefer to have that because the tables are necessary to understand it.

The CHAIRMAN. Put that in the record.

(The document submitted by Mr. Chatters is as follows:)

STATEMENT OF CARL H. CHATTERS, EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA

The information I want to present to your committee today regarding the Federal taxation of the income from State and municipal bonds will be based on recent research and will not duplicate the testimony of other witnesses at this hearing. My appearance here is on behalf of the Municipal Finance Officers Association which I serve as executive director. The point of view I express represents the opinion of the members of the association officially stated at an annual conference and later reaffirmed by the executive board. Our association represents finance and accounting officers of local governments in all States and has among its members such officers from 80 percent of the cities over 50,000 population. The association is a professional, technical, and research group of 1,700 members. My own experience consists of 10 years as city auditor or director of finance of the city of Flint, Mich.; 1 year spent working out financial plans for distressed cities and 10 years in the present position where I am consulting continually with cities on their financial problems. I have served as consultant to Federal agencies and have written one of the four or five books published in the last 10 years on municipal debt.

Your committee will want to consider the essential rights of cities, counties, villages, and other districts to function in peace times as well as in war. The weak community and small unit of government under our scheme of government have the same rights of existence as the strong village and large unit of government. Since local and State governments may soon face serious depression and post-war problems I have tried to see what would happen during such a period if State and municipal bonds are subjected to Federal income taxes. To do this I have studied all recorded municipal bond sales for the years 1919–22 and 1932–34, inclusive.

Taxation of the income from State and municipal securities will surely result in higher interest rates on these bonds and higher interest costs to the States and municipalities. This is my conclusion as a result of my studies, discussions with municipal officials and bond dealers, and observations of the bond market. The testimony of the Treasury's own experts has supported this conclusion. So has the evidence submitted heretofore by others who have made detailed studies of the matter. The increase in the interest cost will be approximately 1 percent per annum; it will be less in some communities, more in others.

Today I propose to pass over the many valid arguments against Federal taxation of State and municipal securities, such as (1) the control that the Federal Government would exercise over the financial operations of States and municipalities, (2) the use of such a device as an entering wedge to tax the revenues of municipalities or States, (3) the fact that no reciprocal advantages are given to the States and localities when the Federal Government taxes their securities, (4) the increased burden on real-estate taxes with little if any reciprocal advantage, and (5) the fact that revenue from the taxation of future issues alone would be negligible for many years to come. Neither do I propose to deal with the taxation of outstanding issues because that is not primarily the concern of the States and cities.

This testimony will demonstrate four points: (1) Thousands of small cities, towns, villages, counties, and school districts, not close to the money centers, will be unable to borrow should their bonds be taxed; (2) in the post-war period or in the depression to follow the war the financial affairs of the large cities as well as the small ones mentioned above will be seriously interfered with. Convincing examples of this will be shown; (3) the ability of cities and States to cooperate with the National Government in a program of post-war public works will be made difficult if not impossible by the taxation of their securities; and (4) the communities which are now extending their facilities to aid the war program will be seriously hampered.

EFFECT OF HIGHER RATES

If State and municipal bonds had been taxable in the past many of them could not have been sold at all. In order to check on the difficulties that would arise from the taxation of the income from municipal bonds and the consequent higher interest rates, I investigated all reported municipal bond sales for the 7 years noted above (1919–22 and 1932–34) to determine the amount of bonds sold at coupon rates of 5¼ percent or higher, the number of municipalities or districts involved, and the number of bond sales taking place at these rates. It is significant, for example, that in 1921, 2,009 municipalities or districts sold 3,000 bond issues totaling $467,015,135 at coupon rates of 5¼ percent or higher. Why do I cite these figures? Had the bonds sold at these rates been taxable the interest rates would have exceeded 6 percent and perhaps would have been as high as 6½ or 7 percent. The history of municipal borrowing shows that bonds are not sold, but are usually withdrawn from the market, if the rates exceed 6 percent. This is due in some cases to constitutional limitations, in others to statutory regulations, and in still others to plain common sense. And in 1922, 1,820 municipalities or districts sold 2,081 issues totaling $130,385,073 at 5¼ percent or more. The number of communities affected and the amount of money involved is impressive. (See table A attached.)

Municipalities cannot pay too high interest rates, for if they do the citizens or the creditors or both will suffer. In general a community cannot safely devote more than 25 percent of its revenue to debt service. When it does the public services must suffer or the community stands to default on its obligations. The usual "ceiling" on interest rates has come to be accepted as 6 percent by the general consensus of State legislatures, fiscal experts, and public officials.

Some of you may think that localities in your States will not be hampered should the interest rates be higher. But note that nearly every State sold some bonds at those high rates (5¼ percent or more) during the period under scrutiny. In Ohio in 1920, for instance, 236 municipalities or districts sold 385 issues totaling $48,748,038 at 5¼ percent or more. And the State of New York in 1920 had 54 municipalities or districts conducting 70 sales with a total of $141,361,537 at these rates. Taking 1921 bond sales for further examples, the

number of communities affected would have been as follows: Indiana, 79; Kansas, 23; Michigan, 38; North Carolina, 128. The city of Flint, Mich., for which I was director of finance, issued very substantial blocks of 6-percent bonds in 1919 and 1920 for school purposes. A summary of municipal bond sales for the years 1919–22, inclusive, and 1932–34, inclusive, by years and by States is shown as table B.

Again you may think that these high rates were confined to 1 or 2 years. However, the high interest rates of 5¾ and 6 percent extended over many years and would have continued for years longer had the income from the bonds been taxable. The records of borrowing in the State of Tennessee, for instance, show that the State or its political subdivisions borrowed at 5½ or 6 percent every year from 1907 to 1940, inclusive, except during 1908, 1912, and 1918. The amount of borrowing during this period at the rates of 5½ or 6 percent was as follows:

State of Tennessee	$14,575,000
67 counties in Tennessee	15,569,750
116 cities and towns in Tennessee	23,303,881
Total	53,448,631

Furthermore, since 1935, refuding bonds have been issued in Tennessee totaling at least $23,340,589 to cure bond defaults by issuing new bonds at lower rates of interest varying from 2¾ to 5 percent.

NEW YORK CITY

Nor would America's largest city have been exempt from the effect of higher interest rates during the depression years, had New York City been required to pay higher interest on taxable bonds. That city was on the verge of default in 1932. To prevent such a staggering occurrence, a group of 50 New York banks and bond houses took $100,000,000 of 3-, 4-, and 5-year notes at 6 percent interest and resold them to the public at the same price. Since the city was permitted by statute to pay no higher than 6 percent interest, and the bonds could be marketed at no lower rate, there would have been no chance to sell the bonds had they been forced to carry a higher rate with the tax-exempt feature gone.

STATE BORROWING HAMPERED

You may think that the State governments themselves are immune from the effect of high interest rates and that the Federal taxation of their instrumentalities would have constituted no interference with their affairs. May I suggest then that you consider the following: During periods of high interest rates State governments have issued bonds and notes at 5¾ or 6 percent. If the sovereign States paid such rates when their bonds were exempt from taxation, will there not be great interference with their actions if their bonds become taxable and therefore subject to interest rates from 0.50 to 1 percent per annum higher? During 1920 five State governments, including Massachusetts, sold bonds, notes, or warrants at 5.85 percent or higher. The Commonwealth of Massachusetts then sold $3,000,000 Boston police strike notes at 5.85 percent. The other States were Georgia, New Mexico, South Dakota, and Utah. During 1921 12 State governments sold long-term bonds at 5¾ percent or more. They were Arkansas, California, Florida, Georgia, Michigan, Nevada, New Mexico, North Carolina, North Dakota, Oregon, South Dakota, and Washington. Michigan in this year (1921) sold $15,000,000 soldier bonus bonds at 5¾ percent and $3,000,000 1-year highway bonds at 6 percent. Eight States during 1921 made revenue loans at rates varying from 6 to 7½ percent per annum. In 1933 South Carolina and Tennessee issued long-term 6 percent State bonds and during 1934 the States of Arizona, Illinois, and South Carolina paid 6 percent on revenue notes. The above cases show that the States are not immune from high interest rates and that their activities will be hampered in a period of high money rates by the higher interest costs arising from the taxation of the income from their bonds.

Going back again to the effect in the individual States, I want to submit data for your committee to show for each of the 7 depression and post-war years

I have studied, the number of communities affected, the number of bond sales at 5¾ percent or more, and the amount involved (see table C). Looking at Minnesota, for instance, with reference to table C you will find that 289 communities conducted 355 sales for a total of $33,302,396. I am submitting therefore for the consideration of the committee table C with the municipal bond sales for the 7 years heretofore mentioned arranged primarily by States, the data for all 7 years for each State being listed together.

SMALL COMMUNITIES OUT

During the past few months I have made contact with scores of persons familiar with the municipal bond market as originating houses or as municipal bond dealers. The conclusion can be drawn beyond any shadow of a doubt that thousands of small communities in the United States, including school districts, counties, townships, and all forms of public organizations, will be unable to borrow should the bonds become taxable and therefore the interest rates higher. This might not be true of the small communities close to the money centers like New York, Boston, and Philadelphia, but it would be true of 90 percent of the smaller communities in the United States. The number of places which might be involved is well indicated by the tables submitted to you. By referring back to my table A you will find that in 1919 there were as many as 758 municipalities that would have been adversely affected, in 1920 there were 1,239; in 1921, 2,009; and in 1922, 1,820. The numbers in 1932, 1933, and 1934 were less because various Federal agencies purchased the bonds of the smaller communities at that time.

BONDS OFFERED—NOT SOLD

A still more serious situation existed during the years 1932, 1933, and 1934. Hundreds of millions of municipal bonds which were offered for sale could find no takers. According to the State and Municipal Compendium there were in 1932, 697 municipal issues totaling $260,000,000 which could find no takers when first offered for sale. While it is true that many of the bonds offered unsuccessfully in 1932 were sold in a later year or were sold to the Federal Government, still had these bonds been taxable, the higher effective interest rates would have remained a bar to sale for 1 year or 2 or 3 years longer. The municipalities or districts involved would have curtailed necessary improvements or necessary financing for a longer period of time. The resulting interference would have been very real in many instances. I recall being called in as consultant by Norfolk, Va., which cut every corner in order to manage an unwieldly debt. Pontiac, Mich., let its streets and hospitals disintegrate because of its debt burden and severely restricted revenues. The city of Minneapolis and the county of Milwaukee were borrowing—and still are borrowing—large sums for relief purposes. Higher interest rates would have lengthened the period during which they were dependent on Federal aid or the period which their public facilities were going to pieces.

REFUNDING

Extensive refunding was carried on by cities and districts for many years subsequent to the depression. Hundreds of refunding programs would have been impossible had the bonds been taxable and the interest rates therefore higher. The refunding of bonds permitted the stabilization of the finances of many communities, and reduced the interest charges to the point where they could be met. Through such stabilization communities were enabled to make a second refunding which still further reduced interest costs and made more money available for operating purposes. Municipalities were able to accomplish through the refunding of their bonds the same thing that industrial corporations always have done; namely, reduce interest charges during period of low interest rates, and get on a more stable financial basis. Let me cite to you the case of the city of Detroit. The city of Detroit refunded $172,242,000 in bonds between 1935 and 1941. The actual interest cost to maturity on these bonds as refunded was $79,486,687 50. Had the interest rates through the Federal taxation of the bonds been 0.50 percent higher the interest cost would have been greater by $12,878,725. Had the interest rates been 0.75 percent greater

the interest cost would have exceeded the present costs by $19,318,102.50. I said earlier that the rates might increase as much as 1 percent or even more. But in this case had the rate been even 0.90 percent per annum higher, the interest cost to the city of Detroit on these refunding bonds would have been greater by $23,178,723.

You may ask if refunding is still an issue with cities. Decidedly it is. Hundreds of defaults still exist which can be cured in no other reasonable way. But thoroughly solvent cities also are refunding to ease their debt burdens and level off their debt requirements. Bridgeport, Conn., is depending on refunding, so are many substantial cities in New York State including Buffalo, Schenectady, and Yonkers. Philadelphia reorganized its debt last year by refunding. So did the Des Moines schools. Because of their drastic tax limits Ohio cities are very dependent on refunding. Minneapolis sold $2,500,000 refunding bonds last December.

Refunding is going on in 1942. During the month of January 1942, 277 municipalities, counties, or districts in 44 States sold bonds. Of these 72 sold refunding issues. In February 229 municipalities or districts in 37 States sold securities and 59 of these sold refunding issues. So refunding is still a vital issue.

POST-WAR PUBLIC WORKS

Much has been said about the building up of a reserve of post-war public works to cushion the tremendous depression and widespread unemployment that may follow the war. The use of State and local public works to forestall a post-war depression has been cited with favor by the President of the United States in his Budget message and in his press conferences. The ability of the States and localities, however, to take part in this effort will be seriously hampered, and effectively wiped out for many communities, if their bonds are subject to taxation and therefore to higher interest rates. The higher rates would take some municipalities out of the market because the rates would then be in excess of the legal maximum. In other cases communities could not cooperate because they could not bear the greater interest costs. In 1932 there were 697 bond issues totaling $260,000,000 [1] that were not purchased by dealers when offered. During the same year the Federal Government, through its various agencies, purchased nearly $130,000,000 of securities of the States and localities. And during the same year (1932) there were $136,000,000 in bonds sold at 5¾ percent or higher. These three groups of securities, totaling more than half a billion dollars, are obligations which the States and localities themselves could not finance in 1932 or would not have been able to finance at higher rates. How can you expect the municipalities to cooperate in a post-war effort if you make it impossible for them to do so. The National Government will be putting out in Federal aid an amount far in excess of the comparatively small amount which you stand to gain by the taxation of future issues of State and municipal bonds. A recent report of the Bureau of Foreign and Domestic Commerce shows that capital outlays in 145 cities declined from $1,071,000,000 in 1930 to $281,500,000 in 1933. This capital outlay was curtailed because the money was not available. Even with all of the pump-priming activities of the National Government the expenditure for municipal public works in 145 cities was three-quarters of a billion less in 1933 than it was in 1930.

In 1932 and the subsequent years the Federal Government was in a far better position to make loans to States and municipalities than it will be in the years following the present war. We cannot help being on the verge of inflation at that time. Further issues of Federal debt will be required if the National Government assists the States and municipalities with public works. On the other hand, issues of State and local government bonds would not bring the same dangers. The ability of the State and local units to borrow money will be an important factor in post-war recovery the same as it has been in several earlier periods in our national history. Even if all other arguments against the Federal taxation of the income from State and municipal bonds are of no avail, then it ought to be worth while to forego Federal taxation of such securities for the sole purpose of permitting the States and local bodies to have their credit resources available at the end of this conflict.

[1] See table D.

INTERFERENCE WITH DEFENSE

The National Government expects the local communities to expand their facilities where it is necessary to do so in order to accommodate military or naval training camps, or to expedite the construction of munition plants. In either case the requirements are great in proportion to the ordinary resources of these communities. Consequently most localities which you select for military establishments or munition centers must rely on borrowed money to finance the construction of the expanded public works.

The mention of a few names will call to your mind the thing I refer to. Norfolk, Va., which already had one of three heaviest debts of our large cities, has been required to expand every facility to meet the needs of the Navy. San Diego, Calif., has had the most phenomenal growth. Other equally good examples are Bremerton, Wash., Portsmouth, N. H., and Corpus Christi, Tex. There are scores of others. The industrial centers for arms production are too well known to mention.

CONCLUSION

Therefore I conclude that Federal taxation of the income from State and municipal bonds would seriously hamper cities, counties, and States in carrying out their assigned war duties; it would prevent them from cooperating fully in a program of post-war public works and it would require them to ask Federal assistance for unemployment relief. The small communities and school districts would be unable to borrow at any time. Scores of larger cities and hundreds of smaller ones would be unable to reorganize their present debts by refunding; the States at times would be seriously handicapped. The ability of all States and local units to take their proper place in a scheme of government built on the theory of local responsibility will be continually challenged if you tax their securities.

To meet the requirements of national defense, all such communities must borrow. Is it reasonable for you to make that borrowing more difficult and more expensive through the imposition of a Federal tax on the income from State and municipal bonds? The revenue you will derive is inconsequential. The difficulties you impose—no matter how small—are a grievous interference with the war program.

TABLE A.—*Municipal bond sales, 1919–22 and 1932–34, at coupon rates of 5¾ percent or more*

	Number of municipalities or districts	Number of bond sales	Amount	Ratio to total sales exclusive of Federal purchases
				Percent
1919	753	935	$64,802,292	8
1920	1,239	1,713	347,646,835	45
1921	2,009	3,000	467,015,135	34
1922	1,820	2,081	139,386,973	11
1932	486	651	136,004,151	17
1933	281	337	44,416,150	7
1934	172	196	20,131,924	2

NOTE.—There were no direct purchases of State and local bonds by the Federal Government in 1919–22. The figure in column 4 for those years is the ratio of sales at 5¾ percent or higher to total sales.

TABLE B.—*Municipal bond sales, coupon rates of 5¼ percent or more, 1919–22 and 1932–34*

[Arranged primarily by years and by States for each year]

MUNICIPAL BOND SALES REPORTED DURING 1919

State	Number of municipalities or districts	Number of bond sales	Amount	State	Number of municipalities or districts	Number of bond sales	Amount
Alabama	7	7	$995,000.00	Nevada	3	3	$230,000.00
Arizona	12	19	1,251,600.00	New Hampshire			
Arkansas	32	40	10,248,000.00	New Jersey	2	2	74,500.00
California	34	57	3,082,456.00	New Mexico	13	14	216,000.00
Colorado	33	36	1,220,900.00	New York	9	9	141,777.00
Connecticut				North Carolina	41	57	3,553,500.00
Delaware	1	1	2,100.00	North Dakota			
Florida	38	54	4,042,938.00	Ohio	106	131	1,708,546.00
Georgia	6	7	378,000.00	Oklahoma	64	80	5,380,606.06
Idaho	40	44	3,555,080.00	Oregon	32	38	4,009,403.00
Illinois	3	3	90,700.00	Pennsylvania	2	2	165,000.00
Indiana	8	9	649,127.00	Rhode Island			
Iowa	7	8	332,000.00	South Carolina	11	12	642,[illegible]60.00
Kansas				South Dakota	2	2	86,000.00
Kentucky	6	6	329,992.00	Tennessee	25	29	2,43[illegible],3[illegible]2.00
Louisiana				Texas	30	35	2,654,570.00
Maine				Utah	5	5	1,495,000.00
Maryland				Vermont			
Massachusetts				Virginia	2	2	100,000.00
Michigan	3	3	361,065.00	Washington	29	45	4,519,249.00
Minnesota	20	21	1,678,500.00	West Virginia	5	6	376,000.00
Mississippi	38	46	2,884,260.00	Wisconsin	4	4	62,340.00
Missouri	9	10	808,060.00	Wyoming	16	17	941,030.00
Montana	36	50	1,792,100.00				
Nebraska	19	21	507,170.00		753	935	64,802,292.00

MUNICIPAL BOND SALES REPORTED DURING 1920

Alabama	6	8	$659,500	Nevada	2	3	$160,000
Arizona	12	16	2,170,000	New Hampshire	1	1	100,000
Arkansas	33	41	9,947,000	New Jersey	33	46	14,691,661
California	53	103	18,930,763	New Mexico	21	24	1,096,000
Colorado	48	76	2,714,000	New York	54	70	141,361,537
Connecticut	1	1	150,000	North Carolina	57	76	9,711,591
Delaware				North Dakota			
Florida	32	40	7,645,335	Ohio	236	385	48,748,038
Georgia	9	9	241,109	Oklahoma	26	28	1,935,400
Idaho	36	46	4,548,740	Oregon	23	34	4,397,998
Illinois	11	11	899,000	Pennsylvania	1	1	2,100
Indiana	61	68	5,381,634	Rhode Island	1	1	90,000
Iowa	36	41	3,587,631	South Carolina	18	20	1,787,000
Kansas	8	8	532,000	South Dakota	13	14	1,208,000
Kentucky	2	2	215,000	Tennessee	22	22	3,170,100
Louisiana				Texas	26	30	5,594,000
Maine	1	1	60,000	Utah	17	20	1,321,000
Maryland	2	2	566,775	Vermont			
Massachusetts	13	15	1,222,400	Virginia	11	14	5,571,500
Michigan	15	20	8,137,503	Washington	35	64	4,630,694
Minnesota	73	94	8,966,007	West Virginia	2	2	135,000
Mississippi	31	44	3,870,300	Wisconsin	14	20	3,347,000
Missouri	29	32	3,669,715	Wyoming	15	16	545,600
Montana	43	81	5,349,536				
Nebraska	56	63	3,518,108		1,239	1,713	347,046,835

TABLE B.—*Municipal bond sales, coupon rates of 5¼ percent or more, 1919–22 and 1932–34*—Continued

MUNICIPAL BOND SALES REPORTED DURING 1921

State	Number of municipalities or districts	Number of bond sales	Amount	State	Number of municipalities or districts	Number of bond sales	Amount
Alabama	14	25	$3,144,500	Nevada	5	5	$603,800
Arizona	15	33	9,753,900	New Hampshire			
Arkansas	24	34	8,521,282	New Jersey	73	102	16,275,892
California	74	166	21,516,262	New Mexico	20	23	1,270,626
Colorado	67	117	5,193,268	New York	115	159	109,511,146
Connecticut	2	2	275,000	North Carolina	128	188	28,871,100
Delaware	1	1	20,000	North Dakota	10	12	1,699,555
Florida	38	51	7,314,150	Ohio	291	551	62,146,468
Georgia	37	41	3,022,000	Oklahoma	28	29	3,006,992
Idaho	38	46	2,883,700	Oregon	57	76	9,524,935
Illinois	11	11	1,389,900	Pennsylvania	19	20	833,150
Indiana	79	119	9,746,013	Rhode Island	1	1	1,186,000
Iowa	71	89	8,830,686	South Carolina	36	51	9,035,200
Kansas	23	25	2,225,441	South Dakota	35	43	3,352,000
Kentucky	13	14	1,209,400	Tennessee	62	80	12,350,326
Louisiana	7	8	3,256,000	Texas	68	81	19,076,983
Maine				Utah	23	25	2,591,338
Maryland	5	5	214,000	Vermont			
Massachusetts	11	14	1,448,750	Virginia	18	20	5,082,000
Michigan	38	50	20,625,000	Washington	40	83	12,981,568
Minnesota	109	151	16,556,829	West Virginia	16	16	1,707,000
Mississippi	42	47	6,629,600	Wisconsin	33	40	7,987,811
Missouri	45	51	6,045,787	Wyoming	27	42	4,106,300
Montana	50	114	7,862,848				
Nebraska	90	139	6,730,729		2,009	3,000	467,015,135

MUNICIPAL BOND SALES REPORTED DURING 1922

Alabama	18	20	$4,521,500.00	Nevada	7	8	$551,000.00
Arizona	24	25	2,493,612.00	New Hampshire			
Arkansas	43	50	5,088,200.00	New Jersey	18	19	2,319,000.00
California	127	127	15,468,103.00	New Mexico	30	31	772,000.00
Colorado	67	77	2,178,800.00	New York	35	37	1,830,423.00
Connecticut	2	2	280,000.00	North Carolina	145	157	10,420,100.00
Delaware				North Dakota	34	34	1,676,900.00
Florida	73	86	11,123,045.00	Ohio	204	290	11,893,858.00
Georgia	20	22	788,000.00	Oklahoma	36	43	3,688,740.00
Idaho	38	40	3,223,693.00	Oregon	55	80	6,367,042.00
Illinois	10	10	1,210,000.00	Pennsylvania	4	4	34,000.00
Indiana	35	40	1,851,326.50	Rhode Island			
Iowa	40	38	2,591,854.00	South Carolina	34	38	3,037,000.00
Kansas	8	8	238,151.00	South Dakota	38	45	1,901,037.00
Kentucky	13	15	1,195,041.00	Tennessee	28	31	3,100,690.00
Louisiana	32	32	2,463,300.00	Texas	103	124	7,728,500.00
Maine				Utah	8	9	675,000.00
Maryland	2	2	50,000.00	Vermont			
Massachusetts				Virginia	18	19	1,729,000.00
Michigan	16	17	1,017,758.00	Washington	35	41	4,812,210.00
Minnesota	73	74	4,351,058.00	West Virginia	9	9	524,000.00
Mississippi	45	46	3,798,500.00	Wisconsin	11	11	601,989.00
Missouri	22	22	1,938,552.00	Wyoming	35	39	1,457,500.00
Montana	48	57	3,238,001.00				
Nebraska	172	202	5,141,460.00		1,820	2,081	139,385,973.50

TABLE B.—*Municipal bond sales, coupon rates of 6¾ percent or more, 1919–22 and 1932–34*—Continued

MUNICIPAL BOND SALES REPORTED DURING 1932

State	Number of municipalities or districts	Number of bond sales	Amount	State	Number of municipalities or districts	Number of bond sales	Amount
Alabama	8	9	$1,810,000.00	Nevada			
Arizona	2	2	97,000.00	New Hampshire			
Arkansas				New Jersey	76	113	$42,697,039.00
California	9	10	3,395,224.00	New Mexico	State	1	
Colorado	4	4	787,300.00	New York	80	96	30,944,205.00
Connecticut	2	2	87,000.00	North Carolina	5	6	598,783.00
Delaware				North Dakota	6	6	41,000.00
Florida				Ohio	119	187	25,020,436.00
Georgia	3	3	49,000.00	Oklahoma	4	4	125,268.00
Idaho	1	1	22,000.00	Oregon	16	24	1,144,388.00
Illinois	5	5	15,053,000.00	Pennsylvania	1	1	5,000.00
Indiana	19	37	3,121,642.00	Rhode Island	1	1	1,200,000.00
Iowa	2	2	35,500.00	South Carolina	1	1	143,000.00
Kansas				South Dakota	2	2	36,000.00
Kentucky	8	9	980,000.00	Tennessee	15	19	1,984,500.00
Louisiana	4	4	65,000.00	Texas	9	9	565,365.00
Maine				Utah	3	3	108,000.00
Maryland				Vermont			
Massachusetts	2	2	1,110,000.00	Virginia	4	6	235,000.00
Michigan	22	26	2,877,080.00	Washington	28	28	923,544.00
Minnesota	4	4	136,560.00	West Virginia			
Mississippi	7	10	397,000.00	Wisconsin	1	1	106,417.00
Missouri	7	7	46,400.00	Wyoming			
Montana	4	4	30,000.00				
Nebraska	2	2	26,500.00	Total	486	651	136,004,151.00

MUNICIPAL BOND SALES REPORTED DURING 1933

Alabama	1	2	$350,000.00	Nevada			
Arizona	1	1	97,766.00	New Hampshire			
Arkansas	1	1	30,000.00	New Jersey	32	37	$6,108,500.00
California	3	3	131,000.00	New Mexico			
Colorado	2	2	45,000.00	New York	41	48	22,895,413.00
Connecticut	1	2	900,000.00	North Carolina	4	5	300,000.00
Delaware	1	1	19,000.00	North Dakota	3	3	925,000.00
Florida	1	1	300,000.00	Ohio	70	84	3,862,970.00
Georgia				Oklahoma	2	2	267,850.00
Idaho	3	3	608,000.00	Oregon	9	12	837,878.00
Illinois	4	4	135,300.00	Pennsylvania	1	1	5,000.00
Indiana	16	22	1,074,786.00	Rhode Island			
Iowa				South Carolina	1	1	75,000.00
Kansas	1	1	75,000.00	South Dakota			
Kentucky	3	3	130,000.00	Tennessee	7	7	451,000.00
Louisiana				Texas	7	7	235,000.00
Maine				Utah	1	1	15,000.00
Maryland				Vermont			
Massachusetts				Virginia	4	4	297,500.00
Michigan	8	8	378,892.00	Washington	7	11	479,000.00
Minnesota	9	10	1,700,292.00	West Virginia			
Mississippi	13	14	715,600.00	Wisconsin	5	7	457,500.00
Missouri	1	1	2,500.00	Wyoming			
Montana	16	26	308,203.00				
Nebraska	2	2	196,200.00	Total	261	337	44,416,150.00

TABLE B.—*Municipal bond sales, coupon rates of 5¼ percent or more, 1919–22 and 1932–34*—Continued

MUNICIPAL BOND SALES REPORTED DURING 1934

State	Number of municipalities or districts	Number of bond sales	Amount	State	Number of municipalities or districts	Number of bond sales	Amount
Alabama	1	1	$100,000.00	Nevada	1	1	$16,000.00
Arizona				New Hampshire			
Arkansas	1	1	25,000.00	New Jersey	22	26	2,694,000.00
California	1	1	200,000.00	New Mexico	1	1	80,000.00
Colorado	3	3	43,500.00	New York	11	13	3,996,650.00
Connecticut				North Carolina	2	2	47,000.00
Delaware				North Dakota	1	1	13,500.00
Florida	1	1	11,000.00	Ohio	72	89	10,356,110.00
Georgia				Oklahoma	5	5	177,639.00
Idaho	1	1	43,000.00	Oregon	13	13	334,725.00
Illinois	3	3	170,500.00	Pennsylvania	2	2	12,500.00
Indiana	4	4	130,000.00	Rhode Island			
Iowa				South Carolina	1	1	82,000.00
Kansas				South Dakota			
Kentucky				Tennessee	5	5	412,000.00
Louisiana	1	1	125,000.00	Texas	3	3	274,000.00
Maine				Utah	1	1	25,000.00
Maryland				Vermont			
Massachusetts				Virginia			
Michigan				Washington	6	7	562,800.00
Minnesota	1	1	2,250.00	West Virginia			
Mississippi	7	7	181,250.00	Wisconsin			
Missouri	1	1	5,000.00	Wyoming			
Montana							
Nebraska	1	1	12,000.00	Total	172	196	20,131,924.00

Source: Compiled from municipal bond sales, as reported annually by the Bond Buyer.

TABLE C.—*Municipal bond sales, coupon rates of 5¼ percent or more 1919–22 and 1932–34*

[Arranged primarily by States with data for all 7 years listed directly under the name of each State]

State	Year	Number of municipalities or districts	Number of sales	Amount	State	Year	Number of municipalities or districts	Number of sales	Amount
Alabama	1919	7	7	$995,000.00	Arkansas	1919	32	40	$10,248,000.00
	1920	6	8	659,500.00		1920	33	41	9,947,000.00
	1921	14	25	3,144,500.00		1921	24	34	8,521,282.00
	1922	18	20	4,521,500.00		1922	43	50	5,088,200.00
	1932	8	9	1,810,000.00		1932			
	1933	1	2	350,000.00		1933	1	1	30,000.00
	1934	1	1	100,000.00		1934	1	1	25,000.00
		55	72	11,580,500.00			134	167	33,859,482.00
Arizona	1919	12	19	1,251,600.00	California	1919	34	57	3,982,450.00
	1920	12	16	2,170,000.00		1920	53	103	18,930,703.00
	1921	15	33	9,753,900.00		1921	74	166	21,516,262.00
	1922	24	25	2,493,612.00		1922	127	127	15,468,103.00
	1932	2	2	97,000.00		1932	9	10	3,395,224.00
	1933	1	1	97,766.00		1933	3	3	131,000.00
	1934					1934	1	1	200,000.00
		66	96	15,863,878.00			301	467	63,623,808.00

TABLE C.—*Municipal bond sales, coupon rates of 5¾ percent or more 1919–22 and 1932–34*—Continued

State	Year	Number of municipalities or districts	Number of sales	Amount
Colorado	1919	33	36	$1,220,900.00
	1920	48	76	2,714,600.00
	1921	67	117	5,193,268.00
	1922	67	77	2,178,800.00
	1932	4	4	787,300.00
	1933	2	2	45,000.00
	1934	3	3	43,500.00
		224	315	12,183,368.00
Connecticut	1919	.....	.....	.....
	1920	1	1	150,000.00
	1921	2	2	275,000.00
	1922	2	2	280,000.00
	1932	2	2	87,000.00
	1933	1	2	900,000.00
	1934	.....	.....	.....
		8	9	1,692,000.00
Delaware	1919	1	1	2,100.00
	1920	.....	.....	.....
	1921	1	1	20,000.00
	1922	.....	.....	.....
	1932	.....	.....	.....
	1933	1	1	19,000.00
	1934	.....	.....	.....
		3	3	41,100.00
Florida	1919	38	54	4,042,938.00
	1920	32	40	7,645,335.00
	1921	38	51	7,314,150.00
	1922	73	86	11,123,045.00
	1932	.....	.....	.....
	1933	1	1	300,000.00
	1934	1	1	11,000.00
		183	233	30,436,468.00
Georgia	1919	6	7	376,000.00
	1920	9	9	241,109.00
	1921	37	41	3,022,000.00
	1922	20	22	778,000.00
	1932	3	3	49,000.00
	1933	.....	.....	.....
	1934	.....	.....	.....
		75	82	4,466,109.00
Idaho	1919	40	44	3,555,080.00
	1920	36	46	4,548,740.00
	1921	38	46	2,883,700.00
	1922	38	40	3,223,693.00
	1932	1	1	22,000.00
	1933	3	3	608,000.00
	1934	1	1	43,000.00
		157	181	14,884,213.00
Illinois	1919	3	3	90,700.00
	1920	11	11	899,000.00
	1921	11	11	1,389,900.00
	1922	10	10	1,210,000.00
	1932	5	5	15,053,000.00
	1933	4	4	135,300.00
	1934	3	3	170,500.00
		47	47	18,948,400.00
Indiana	1919	8	9	$649,127.00
	1920	61	68	5,381,634.00
	1921	79	119	9,746,013.00
	1922	35	40	1,851,326.50
	1932	19	37	3,121,042.00
	1933	16	22	1,074,786.00
	1934	4	4	130,000.00
		222	299	21,954,528.50
Iowa	1919	7	8	332,000.00
	1920	36	41	3,587,631.00
	1921	71	89	8,630,586.00
	1922	40	38	2,591,854.00
	1932	2	2	35,500.00
	1933	.....	.....	.....
	1934	.....	.....	.....
		156	178	15,177,571.00
Kansas	1919	.....	.....	.....
	1920	8	8	532,000.00
	1921	23	25	2,225,441.00
	1922	8	8	238,151.00
	1932	.....	.....	.....
	1933	1	1	75,000.00
	1934	.....	.....	.....
		40	42	3,070,592.00
Kentucky	1919	6	6	329,992.00
	1920	2	2	215,000.00
	1921	13	14	1,209,400.00
	1922	13	15	1,195,041.00
	1932	8	9	980,000.00
	1933	3	3	130,000.00
	1934	.....	.....	.....
		45	49	4,059,433.00
Louisiana	1919	.....	.....	.....
	1920	.....	.....	.....
	1921	7	8	3,256,000.00
	1922	32	32	2,403,300.00
	1932	4	4	65,000.00
	1933	.....	.....	.....
	1934	1	1	125,000.00
		44	45	5,909,300.00
Maine	1919	.....	.....	.....
	1920	1	1	60,000.00
	1921	.....	.....	.....
	1922	.....	.....	.....
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	.....	.....	.....
		1	1	60,000.00
Maryland	1919	.....	.....	.....
	1920	2	2	566,775.00
	1921	5	5	214,000.00
	1922	2	2	50,000.00
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	.....	.....	.....
		9	9	830,775.00

TABLE C.—*Municipal bond sales, coupon rates of 5¼ percent or more 1919–22 and 1932–34*—Continued

State	Year	Number of municipalities or districts	Number of sales	Amount
Massachusetts	1919	.....	.....	.....
	1920	13	15	$1,222,400.00
	1921	11	14	1,448,750.00
	1922	.....	.....	.....
	1932	2	2	1,110,000.00
	1933	.....	.....	.....
	1934	.....	.....	.....
		26	31	3,781,150.00
Michigan	1919	3	3	361,065.00
	1920	15	20	8,137,503.00
	1921	38	50	20,625,000.00
	1922	16	17	1,017,750.00
	1932	22	26	2,877,080.00
	1933	8	8	378,892.00
	1934	.....	.....	.....
		102	124	33,397,290.00
Minnesota	1919	20	21	1,678,500.00
	1920	73	94	8,966,907.00
	1921	109	151	16,556,829.00
	1922	73	74	4,351,058.00
	1932	4	4	136,500.00
	1933	9	10	1,700,202.00
	1934	1	1	2,250.00
		289	355	33,392,396.00
Mississippi	1919	38	46	2,884,260.00
	1920	31	44	3,879,300.00
	1921	42	47	6,629,600.00
	1922	45	46	3,798,500.00
	1932	7	10	397,000.00
	1933	13	14	715,600.00
	1934	7	7	181,250.00
		183	214	18,485,510.00
Missouri	1919	9	10	808,000.00
	1920	29	32	3,669,715.00
	1921	45	51	6,045,787.00
	1922	22	22	1,958,582.00
	1932	7	7	46,400.00
	1933	1	1	2,600.00
	1934	1	1	5,000.00
		114	124	12,536,044.00
Montana	1919	36	50	1,702,100.00
	1920	43	81	5,349,536.00
	1921	50	114	7,862,848.00
	1922	48	57	3,238,001.00
	1932	4	4	30,000.00
	1933	16	26	308,203.00
	1934	.....	.....	.....
		197	332	18,580,688.00
Nebraska	1919	19	21	507,170.00
	1920	56	63	3,518,108.00
	1921	90	139	6,730,729.00
	1922	172	202	5,141,460.00
	1932	2	2	26,500.00
	1933	2	2	196,200.00
	1934	1	1	12,000.00
		342	430	16,132,167.00
Nevada	1919	3	3	$230,000.00
	1920	2	3	160,000.00
	1921	5	5	603,800.00
	1922	7	8	551,000.00
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	1	1	16,000.00
		18	20	1,560,800.00
New Hampshire	1919	.....	.....	.....
	1920	1	1	100,000.00
	1921	.....	.....	.....
	1922	.....	.....	.....
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	.....	.....	.....
		1	1	100,000.00
New Jersey	1919	2	2	74,500.00
	1920	33	46	14,091,661.00
	1921	73	102	16,275,892.00
	1922	18	19	2,319,000.00
	1932	76	113	42,697,030.00
	1933	32	37	6,108,500.00
	1934	22	26	2,694,000.00
		256	345	84,860,592.00
New Mexico	1919	13	14	216,000.00
	1920	21	24	1,096,060.00
	1921	20	23	1,270,626.00
	1922	30	31	772,000.00
	1932	1	1	1,000,000.00
	1933	.....	.....	.....
	1934	1	1	80,000.00
		86	94	4,434,686.00
New York	1919	9	9	141,777.00
	1920	54	70	141,361,537.00
	1921	116	169	109,511,146.00
	1922	35	37	1,830,423.00
	1932	80	96	30,944,205.00
	1933	41	48	22,895,413.00
	1934	11	13	3,996,650.00
		345	432	310,681,151.00
North Carolina	1919	41	57	3,553,500.00
	1920	57	76	9,711,591.00
	1921	128	188	28,871,100.00
	1922	145	157	10,426,100.00
	1932	5	6	598,783.00
	1933	4	5	306,000.00
	1934	2	2	47,000.00
		382	491	53,514,074.00
North Dakota	1919	.....	.....	.....
	1920	.....	.....	.....
	1921	10	12	1,099,555.00
	1922	34	34	1,676,900.00
	1932	6	6	41,000.00
	1933	3	3	925,000.00
	1934	1	1	13,500.00
		54	56	4,355,955.00

[1] State.

TABLE C.—*Municipal bond sales, coupon rates of 5¼ percent or more 1919–22 and 1932–34*—Continued

State	Year	Number of municipalities or districts	Number of sales	Amount
Ohio	1919	106	131	$1, 708, 546. 00
	1920	236	385	48, 748, 038. 00
	1921	291	551	62, 146, 468. 00
	1922	204	290	11, 893, 858. 00
	1932	119	187	25, 020, 436. 00
	1933	70	84	3, 862, 970. 00
	1934	72	89	10, 356, 110. 00
		1,098	1,717	163, 736, 426. 00
Oklahoma	1919	64	80	5, 389, 600. 00
	1920	26	28	1, 035, 400. 00
	1921	28	29	3, 005, 992. 00
	1922	36	43	3, 688, 740. 00
	1932	4	4	125, 268. 00
	1933	2	2	267, 850. 00
	1934	5	5	177, 639. 00
		165	191	14, 591, 495. 00
Oregon	1919	32	38	4, 909, 403. 00
	1920	23	34	4, 397, 998. 00
	1921	57	76	9, 524, 935. 00
	1922	55	80	6, 367, 042. 00
	1932	16	24	1, 144, 388. 00
	1933	9	12	837, 878. 00
	1934	13	13	334, 725. 00
		205	277	27, 516, 369. 00
Pennsylvania	1919	2	2	165, 000. 00
	1920	1	1	2, 100. 00
	1921	19	20	833, 150. 00
	1922	4	4	34, 000. 00
	1932	1	1	5, 000. 00
	1933	1	1	5, 000. 00
	1934	2	2	12, 500. 00
		30	31	1, 056, 750. 00
Rhode Island	1919	.....	.....	.....
	1920	1	1	90, 000. 00
	1921	1	1	1, 186, 000. 00
	1922	.....	.....	.....
	1932	1	1	1, 200, 000. 00
	1933	.....	.....	.....
	1934	.....	.....	.....
		3	3	2, 476, 000. 00
South Carolina	1919	11	12	642, 500. 00
	1920	18	20	1, 787, 000. 00
	1921	36	51	9, 035, 200. 00
	1922	34	38	3, 037, 000. 00
	1932	1	1	143, 000. 00
	1933	1	1	75, 000. 00
	1934	1	1	82, 000. 00
		102	124	14, 801, 700. 00
South Dakota	1919	2	2	85, 000. 00
	1920	13	14	1, 208, 000. 00
	1921	35	43	3, 352, 000. 00
	1922	38	46	1, 901, 037. 00
	1932	2	2	36, 000. 00
	1933	.....	.....	.....
	1934	.....	.....	.....
		90	106	6, 582, 037. 00
Tennessee	1919	25	29	$2, 430, 323. 00
	1920	22	22	3, 170, 100. 00
	1921	62	80	12, 350, 326. 00
	1922	28	31	3, 100, 690. 00
	1932	15	19	1, 084, 500. 00
	1933	7	7	451, 000. 00
	1934	5	5	412, 000. 00
		164	193	23, 898, 939. 00
Texas	1919	30	35	2, 654, 570. 00
	1920	26	30	5, 594, 000. 00
	1921	68	81	19, 076, 983. 00
	1922	108	124	7, 728, 500. 00
	1932	9	9	565, 365. 00
	1933	7	7	235, 000. 00
	1934	3	3	274, 000. 00
		251	289	36, 128, 418. 00
Utah	1919	5	5	1, 495, 000. 00
	1920	17	20	1, 321, 000. 00
	1921	23	25	2, 501, 338. 00
	1922	8	9	675, 000. 00
	1932	3	3	108, 000. 00
	1933	1	1	15, 000. 00
	1934	1	1	25, 000. 00
		58	64	6, 230, 338. 00
Vermont	1919	.....	.....	.....
	1920	.....	.....	.....
	1921	.....	.....	.....
	1922	.....	.....	.....
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	.....	.....	.....
Virginia	1919	2	2	100, 000. 00
	1920	11	14	5, 571, 500. 00
	1921	18	20	5, 082, 000. 00
	1922	18	19	1, 720, 000. 00
	1932	4	6	235, 000. 00
	1933	4	4	297, 500. 00
	1934	.....	.....	.....
		57	65	13, 015, 000. 00
Washington	1919	29	45	4, 519, 249. 00
	1920	35	64	4, 680, 694. 00
	1921	40	83	12, 981, 568. 00
	1922	35	41	4, 812, 210. 00
	1932	28	28	923, 544. 00
	1933	7	11	479, 000. 00
	1934	6	7	562, 300. 00
		180	279	28, 958, 565. 00
West Virginia	1919	5	6	376, 000. 00
	1920	2	2	135, 000. 00
	1921	16	16	1, 707, 000. 00
	1922	9	9	524, 000. 00
	1932	.....	.....	.....
	1933	.....	.....	.....
	1934	.....	.....	.....
		32	33	2, 742, 000. 00

TABLE C.—*Municipal bond sales, coupon rates of 5¾ percent or more 1919–22 and 1932–34*—Continued

State	Year	Number of municipalities or districts	Number of sales	Amount	State	Year	Number of municipalities or districts	Number of sales	Amount
Wisconsin	1919	4	4	$62,340.00	Wyoming	1919	16	17	$941,930.00
	1920	14	20	8,347,000.00		1920	15	16	545,600.00
	1921	33	40	7,987,811.00		1921	27	42	4,106,300.00
	1922	11	11	601,989.00		1922	35	39	1,457,500.00
	1932	1	1	106,417.00		1932			
	1933	5	7	457,500.00		1933			
	1934					1934			
		68	83	17,563,057.00			93	114	7,051,330.00

TABLE D

MUNICIPAL BOND SALES, 1932-34

	Long-term loans [1] (1)	Bonds included in (1) purchased by Federal agencies [1] (2)	Bonds included in (1) sold at 5¼% or higher [1] (3)
1932:			
Amount	$936,855,060	$129,600,557	$136,004,151
Number of issues	3,093		651
1933:			
Amount	$1,127,576,381	$484,275,249	$44,416,150
Number of issues	2,516		337
1934:			
Amount	$1,175,333,698	$288,644,403	$20,131,924
Number of issues	4,630		196

MUNICIPAL BONDS OFFERED BUT NOT SOLD, 1932-34

	Number of issues	Amount	Ratio of bonds not sold to amount of sales exclusive of purchases by Federal agencies
			Percent
1932	697	$260,089,158	32
1933	528	211,899,796	34
1934	243	70,889,715	8

[1] From Municipal Bond Sales by The Bond Buyer.
[2] Computed by Chatters.

Mr. TOBIN. The city auditor of Boston would like to make a very short statement.

The CHAIRMAN. Yes; he may come around now.

STATEMENT OF CHARLES J. FOX, CITY AUDITOR, BOSTON, MASS.

Mr. FOX. Mr. Chairman, I intend to be brief, and I think I can carry out that intention by standing, rather than sitting in this comfortable chair.

The CHAIRMAN. That is quite agreeable to the committee, sir.

Mr. Fox. I might say that I have been 20 years a finance officer of the city of Boston, the last 8 years as a city auditor.

I also am the immediate past president of the Municipal Finance Officers Association and at the present time I am serving on a recess legislative commission in Massachusetts, on the subject of intergovernmental relations.

My chief concern, in the proposal that is before you, as a municipal finance officer, is in the immediate and the long-range effects that the possible adoption of this proposal might have on the cost and administration of local government.

Now, I contend that the immediate effect of the adoption of this proposal would be the increasing of the costs of local borrowing.

I appreciate that, in making that contention, I am running possibly afoul of some ideas that Senator Taft expressed this morning, but I think the Senator overlooks the fact that this is a union of 48 States, and that we have 48 varieties of local finance laws.

In the State I come from, local borrowings involve a lot more than simply borrowing for capital improvements. In fact, I might state that local borrowings for capital improvements constitute a minor item in our borrowing program.

Our cities operate on a calendar-year basis, and under the State law there is no penalty attached to the nonpayment of taxes until November 1.

That means that, for 10 months of the year, we have to operate on borrowed money, tax notes, and I assume that these tax notes, as municipal securities, would come under the particular provision we are discussing.

In my city, in 1 year, we have borrowed as high as $45,000,000 in anticipation of revenues.

In recent years, under good collection procedure, we have dropped as low as $30,000,000, but I am afraid that we are on the upward trend, because of revenue conditions over which we have no control.

The last figures I saw in the entire State showed borrowings in anticipation of revenue at close to a hundred million dollars.

The CHAIRMAN. What is the prevailing rate on these borrowings in anticipation of taxes?

Mr. Fox. We have been as low as 25, and our last borrowing was 69.

Some other cities and towns in Massachusetts borrow at a little lower rate than Boston.

We have been as high as 4¼ percent on temporary notes.

The CHAIRMAN. On temporary notes?

Mr. Fox. Yes, sir.

As I say, the last figures I saw for the entire State were a hundred million dollars in temporary notes.

Now, there is a substantial item.

It is true that these are short-term obligations, but nevertheless the interest on these notes, on a hundred million dollars, is substantial.

We have another item of borrowing in Massachusetts which may be peculiar to our State, and that is borrowing for public welfare.

Public welfare is a must expenditure on local communities in Massachusetts.

The State welfare act says that the local communities shall provide for the care of the needy and the unfortunate. In my city we have spent as high as $15,000,000 in 1 year in direct relief.

At the present time we are spending about $9,000,000 a year.

That includes the three categories and is exclusive of Federal aid and aid from the State.

The State has never seen fit to establish taxes to aid municipalities in the financing of the welfare burden. The only out they have given us is to permit us to borrow for that particular purpose.

In Boston we have been borrowing; since 1933 we have borrowed over $30,000,000 for welfare.

I do not attempt to defend borrowing for current maintenance but nevertheless, when it is the only way out to relieve the taxpayers, we have necessarily had to follow it.

I had hoped that we had reached the end of the road in that particular type of borrowing, but recently our welfare rolls have shown a tendency to go up, and next year I am doubtful whether we can get out of this questionable means of borrowing.

Recently the State legislature has authorized municipalities to borrow for civilian defense.

So far, in my city, we have borrowed a very negligible sum—$300,000—but being a coastal city and being subject to attack from the air this particular type of borrowing might reach sizable figures if invasion should be our lot.

Now, there are three types of local borrowings which possibly are not to be found in Ohio, but they prove, I think, that you cannot form an opinion simply on one State or on one city.

You have to review the entire United States, and its variety of local finance laws.

Now, I don't think anybody will object, or say I am wrong, when I claim that these increased interest rates will fall on one direct class, and that is the property owners. They are the principal supporters of municipal costs and municipal government, and any measure that is bound to result in increasing those costs cannot be evaded or escaped by this particular class.

Insofar as the long-range possibility is concerned, I think I can contend that borrowing is a necessary and important element in local financing, and the differential in interest which has existed between private and public borrowings in past years has made it possible for the small as well as the large communities in this country to borrow for these public improvements.

I agree with Mayor LaGuardia that we are going to win this war, but that it may be a long period before final victory is secured.

The longer that period of victory is delayed the more need we are going to have in this country for a program of public works.

Now, if you are going to make it harder for municipalities to borrow, by adding on additional carrying charges through the adoption of this legislation, it seems to me you are flying a red flag in the face of the success of this public works post-war program.

Senator TAFT. Mr. Fox, regarding your current borrowing: What is the total budget of the city of Boston?

Mr. FOX. The total budget, including everything, is $80,000,000.

Senator TAFT. If you borrowed $30,000,000 in an average period of 6 months, I suppose, and if that made a difference of as much as a half of 1 percent in your borrowing, I estimate that it would cost the city $75,000 over and above what it would otherwise cost—it would add $75,000 to an $80,000,000 budget: are those figures approximately correct, Mr. Fox?

Mr. FOX. We borrow for longer periods than that, Senator. We borrow 9 months and 12 months.

Senator TAFT. I was just figuring an average: Say, borrowing in January against November collections, your average wouldn't run over 6 months, and I should think the total additional interest cost, assuming a doubling, practically, of the rates you have been paying, would only come to $75,000 in a year.

Mr. FOX. It is my impression it would run higher than that.

Senator TAFT. One percent would be $300,000 for a whole year, and for 6 months it would be $75,000.

I only think that your general statement makes rather an over picture of the additional cost resulting for current borrowing.

I quite agree with your argument as to post-war, but as to the immediate cost it seems to me that is a negligible item.

Mr. FOX. Senator, I still think you are thinking in terms of Cincinnati.

Senator TAFT. No. I am taking your own figures. We have borrowed for current expenses in the past—it has been done—and it may have to be done again, although it is prohibited by law.

My only point was that, on your own figures of your own borrowing, it wouldn't cost you but $75,000 on an $80,000,000 budget, and I say it is a negligible feature in the question——

Mr. Fox (interposing). Well, Senator, a hundred thousand dollars means 10 cents per thousand to us, in our tax rate. Our current year's tax rate is $41. Now, 10 cents in the Cincinnati rate might be negligible, but it is not negligible when you have a $41 tax rate.

Senator TAFT. I say $75,000 is negligible in an $80,000,000 budget, I don't care how you get it or where your tax rate comes from.

Mr. FOX. Well, you have been fortunate to live in a city that has been particularly favored. There are not so many of those large cities in this country.

There is one final point I would like to make in conclusion, Mr. Chairman.

I believe this is the fifth year this proposition has been under consideration by Congress.

Now, the removal of the tax exemption on State and municipal bonds is but one element in the whole complicated system of fiscal relations that exist in this country, between the Federal, State and local levels of government.

Now, it seems to me that consideration of an isolated element gets nowhere in the finding of a solution for the entire complicated system.

I appreciate that, during the past 5 years, this committee and the committee in the House has had to devote considerable time and study because of the Treasury's insistence on the removal of this feature.

I only wish that you had been able to utilize that time and that effort in making a general and an over-all review of the fiscal relations between the levels of government in this country.

We are now engaged in a conflict in which the maintenance and the preservation of democracy as a form of government is at stake.

We have no question about the outcome of the issue, but I submit this:

If, in a worldwide conflict to save democracy, we are successful, and then we neglect or overlook the necessity for taking a broad general view in our own country of this complicated fiscal set-up that we have, I think, in the end, we will have won a hollow victory.

I am interested in the maintenance of strong and virile units of local government.

I think they constitute the bulwark of democracy. I think their continued existence, in the years that lie ahead, depends on the attitude and actions of Congress.

I appreciate that war problems necessarily must receive most of your attention and thoughts, but I sincerely hope that, in the not too distant future, you will find time to make this general appraisal, this general review and study, of the entire fiscal relations in the country.

I advocate and suggest current study of this particular feature, because, even in the throes of war, there is need for foresight.

Thank you.

The CHAIRMAN. Thank you very much.

Mr. TOBIN. Senator, Mayor Green, of Birmingham, is here now and he would like to submit his statement for the record.

The CHAIRMAN. Yes, sir. Mayor Green, you may come around.

STATEMENT OF W. COOPER GREEN, MAYOR, BIRMINGHAM, ALA.

Mr. GREEN. Mr. Chairman and Senators, I would just like to file my statement.

I am representing the southern cities, United States Conference of Mayors.

I have it prepared, and I would like to file it.

The CHAIRMAN. You may do so.

(The statement submitted by Mayor Green is as follows:)

STATEMENT BY COOPER GREEN, MAYOR OF BIRMINGHAM, ALA., ON FEDERAL TAXATION OF INCOME FROM LOCAL GOVERNMENT SECURITIES

The Treasury's proposal is to tax the income from all Government bonds. Included therein were those bonds already issued, as well as future issues. The House Ways and Means Committee, as well as this committee, in their wisdom saw fit to promptly reject the suggestion of taxing income from past issues. From the standpoint of fairness and equity to all concerned, these committees are to be complimented for their negative action in that regard. My remarks, therefore, shall be confined to the essential facts regarding the proposal to tax income from future issues, and how it will affect the local government level.

Financially, the imposition of this tax would affect three different groups, namely, the Federal level of Government, the local level, and certain bondholders (but not all bondholders).

1. THE FEDERAL LEVEL'S PURPORTED GAINS

The result of this tax if placed on future issues, might result in some small immediate gain in revenues to the Federal Government. It is claimed that this increase in revenue at the most, would be only infinitesimal for several years. At first, it would likely be as little as three to five million dollars annually. It would probably be a quarter of a century before any substantial gain could be reasonably expected.

It is quite conceivable that through the reciprocity treatment, whereby local governments would be permitted to levy a tax on Federal Government bonds, that the imposition of this tax might result in a material loss to the Federal Government for several years to come. No one can foretell at this time how great an amount of financing our Federal Government must do within the next few years. It will unquestionably be many tens of billions of dollars. If income from these new Federal securities is made subject to local government income taxes as the Treasury has suggested, it would seem that the net loss in Federal revenues might be a most extraordinary amount. Local governments are not materially increasing their debt. Therefore, there is no sound argument in advancing this proposal as a war measure. With these facts in mind, it is a matter of great concern to those of us in local government as to what the true motive might be, in this attempted further invasion of the local tax field and local sovereignty.

2. LOCAL GOVERNMENT'S ASSURED FINANCIAL LOSS

At long last the Treasury Department has agreed that the imposition of the tax would result in an increased interest cost to the issuing authority. The only difference between the proponents and the opponents in this regard, is the amount of the increase. That difference is not too great. When using the best authorities available on the subject, namely, disinterested security dealers and economists generally, we are convinced that the increase in our interest cost would be some one-half to three-fourths percent, varying according to local conditions. The Federal Treasury is claiming probably about one-half as much. In any event, it will be a material increase. It is wholly reasonable to expect an increase of 20 to 30 percent in our present cost of financing. That amount is a matter of serious concern to every local Government official, particularly in these times when all Governments are called upon for more and more public services than ever before. This great increase in costs would unquestionably seriously interfere with our capital financing of those public improvements, that will be so necessary after the war.

It can well have a very serious effect on the ability of the local government to take care of its share of the relief load when it next appears in the proportions that it did in the thirties. If that should happen, it would simply mean that more of this relief expense would be thrown back on the Federal Government because of the inability of the local government to pay its share and carry on. That, in itself, might easily offset any gain in Federal income taxes. Those of us who have been closely associated for a number of years in relief administration, believe it is highly desirable that the cities' fiscal position should be maintained, whereby when the time does come, we will be in a position through capital improvement financing or otherwise, to carry our portion of this relief load.

Local governments recognize their responsibilities and are ready, anxious, and willing to meet them insofar as it is possible to do. We ask you not to impede and hamper us by legislation that could well make impossible the discharge of the primary functions of local government. Freedom in finance is the soul of any government. "Save our souls."

3. BONDHOLDERS' INTEREST

We will now consider the case of the bondholder, particularly that great bogeyman who spends his winters in Miami and there clips his so-called tax-free coupons. The local government is not any more concerned in the welfare of this bogeyman than is Secretary Morgenthau. He can well take care of himself. There are, however, some elemental facts that we are no going to overlook, although it would appear that the Treasury Department is ever failing to recognize them.

The bogeyman, we dare say, is not at all interested in whether the income from future issues is taxed or not. If the income from future issues is made taxable, he will still be at Miami clipping his interest coupons—with this difference, the coupons will be in a larger amount—sufficiently larger to take care of whatever amount of income tax he would have to pay. It would simply be a case of him collecting and putting more money in one pocket and then again paying out this extra money to the Federal Government. Consequently, the bogeyman isn't going to shed any tears as a result of anything that Congress does in this case. He knows and we know that heretofore he has prepaid his tax. This was done in the way of him buying the local government bond at a much less interest cost to the issuing authority. The net result of it all is that he paid this tax in advance to the local government rather than to the Federal Government.

Under our dual system of American Government, we claim that this is one of local government's inalienable constitutional rights, and one not to be interfered with by the Federal Government except through a constitutional amendment. If the American people want to change the form of their Government, they have a right to do it through the amendatory process. If they want to increase Federal power and decrease local government authority, we claim that it should be done through the amendment process, and not otherwise. We are good Americans. After the issue has once been fully understood by our citizens, we will cheerfully abide by their decision. No legislative body should attempt to usurp this prerogative of the people, through any sort of a "short and simple statute," as it has been suggested.

Included among the bondholders are certain groups who no doubt are greatly interested and would be benefited by the imposition of this tax. I have reference to institutional buyers, pension groups, sinking funds, and other associations who ordinarily are not subject in any event to the Federal income-tax law. Yes, they would benefit by the imposition of the tax and they would benefit at the expense of the local government without any benefit whatever accruing to the Federal Government. About one-third of the total local government bonds are held by these tax-exempt holders. Almost a similar amount of bonds is held by commercial banks and insurance companies and other corporations who ordinarily are not affected by excess-profit taxes. In those cases, we would have the result of placing a heavy additional burden on local government without benefiting the Federal level.

LOOPHOLES

What are these so-called loopholes in our present tax system. Is it a loophole simply because the tax is prepaid to the local level rather than to the Federal level? Even if everything they claim was true regarding the so-called loophole, what do we have? Using the Treasury Department's own records it is found that in all estates of $50,000 or more that cleared through their Department for the 13 years that ended in 1939, only 6 percent of those estates were invested in local government securities. That, indeed, is a surprisingly small amount. If it were any less than that, I think that we might well claim that these "Miamites" were shirking their duty and responsibility in not properly supporting the local level of government by a larger investment of their funds in these bonds.

We believe the time has come when Congress should definitely close the door on this proposal. This agitation should be stopped. It is hurting all levels. If enacted into law, this proposal would not materially benefit the Federal level—at least for a very long time to come. It will greatly injure the local level. The different levels of Government should recognize the rights of each other and work together, rather than to opposite ends.

I believe the opposition of all local government to this proposal is largely summed up in the resolution that was officially adopted by the governing body of the city of Birmingham on February 10, 1942. A copy of that resolution is as follows:

"Whereas it is obvious that the economic effect of Federal taxation of the income from municipal bonds would be the exaction by bondholders of interest rates upon future issues of municipal bonds sufficiently high to exonerate them from the burden of such taxation, and to cast such burden upon the general revenues of the issuing municipalities; and

"Whereas such Federal taxation would amount to no more than disguised Federal taxation of the tax revenues of municipalities, and would be but another step toward destruction of the sovereignty of the States and their instrumentalities; and

"Whereas a tax on future issues of State and municipal bonds would raise practically no revenues whatsoever at this time, and no appreciable amount of revenue for a very long time to come, but would immediately very substantially increase the cost of necessary municipal borrowing; and

"Whereas Secretary Morgenthau's proposal to also tax income from local government bonds now outstanding would clearly be on the part of the Federal Government a violation of implied contract rights on the part of the purchaser and holder of those bonds, and which implied rights have been recognized for many years by the Federal Government; and

"Whereas such a breach of good faith on the part of the Federal Government would be one of dishonor, and would serve to impair the confidence of the people in their Government's pledges: Therefore be it

"Resolved by the Commission of the City of Birmingham as follows:

"1. That this commission do, and it does, hereby express its determined opposition to any proposal for Federal taxation of the income from municipal bonds, either those to be later issued or those already issued.

"2. That the city clerk be, and she hereby is, instructed to send a certified copy of this resolution to each member of the Senate and House of Representatives from Alabama, and to each member of the Senate Finance Committee and the House Ways and Means Committee."

In closing I wish to quote from a talk recently made by the Hon. David M. Wood, of Thomson, Wood & Hoffman, New York City: "We are all united in support of the Administration in the conduct of the war. Whatever is necessary to win the war we will do. Whatever sacrifice is necessary, however great, we will make. But it is also the duty of the administration not to weaken the Nation by fomenting domestic strife while we are confronted with external enemies. This is no time for the Federal Government to cause irritations by seeking to tax municipalities or other subdivisions of the State." This is exactly what we claim the proposed legislation would do. It is simply a shifting of the place where the tax payment would be paid. It is not prepaid to the local government, while the Treasury Department is seeking to have that payment diverted and transferred to the Federal Government.

Respectfully submitted.

COOPER GREEN,
Mayor, City of Birmingham, Ala.

The CHAIRMAN. Thank you very much.

Mr. TOBIN. I would like to conclude now, Senator, with the testimony of Solicitor General Epstein, of New York.

STATEMENT OF HENRY EPSTEIN, SOLICITOR GENERAL, STATE OF NEW YORK

Mr. EPSTEIN. The statement that I have will take not more than 5 minutes, but before beginning that statement I should like, if this committee will permit me, to address myself to several of the peripheral questions that have been discussed this morning.

I first would like to address myself to some of the questions that emanated from some figures that Senator Brown gave, presumably relying upon statements given to him by a representative of the Treasury Department, in regard to the relationship between the increasing income taxes and the possible escape of those who hold large estates.

The figures given in the 1942 hearings before the House Ways and Means Committee, volume 3, page 3087, Treasury figures, show that, from the year 1939 to the year 1940, the holdings in tax-exempt securities of the type under discussion here fell off from 22.7 percent in estates over a million dollars in 1939 to 15.1 percent in 1940, or a drop of approximately 33 percent in the holdings of those securities in estates of more than a million dollars, in the Treasury's own figures, and in the lesser estates a corresponding drop in holdings.

Senator BROWN. I got my figures from the report of the Treasury made in 1938, on estates that filed their returns in the year 1938.

In 1939, at the time the figures were given, they were effective as of 1938.

Mr. EPSTEIN. As to those 1938 figures, were the number of estates enumerated, as to how many there were?

Senator BROWN. Yes.

Mr. EPSTEIN. But the indications here, with the constantly increasing income taxes, would show that there has been a lessening of the extent to which those large estates are invested in those tax-exempt securities.

The CHAIRMAN. How do you explain that?

Mr. EPSTEIN. They seek control of investments elsewhere, and the total results over a period of 15 years will show that the totals of the large estates are so small that to actually be considered, with the existing outstanding issues, as a source of revenue, they would be negligible.

Now, let me reinforce that possible avenue of attack by the comparison of the experience of the Federal Government and the State of New York simultaneously in January 1941, in issuing in the one case taxable securities and in the case of the State of New York tax-exempt securities:

In January of 1941 the United States Treasury borrowed $200,000,000 on 5- to 10-year notes, paid 2 percent. They were taxable.

Now, the security of the United States of America, we will all readily concede, is at least as good if not better than the State of New York.

The CHAIRMAN. They were wholly taxable?

Mr. EPSTEIN. Wholly taxable.

The State of New York sold $20,000,000 of tax-exempt State bonds to aid in the public-housing program, pursuant to a constitutional amendment which had passed in 1938, and sold those $20,000,000 of bonds, which are amortizable over a period of 50 years, at 1.72 percent. They were tax exempt. There is no question but that the Federal Government could have sold them at least 1.5 instead of 1.72. At least their credit would have been equal to the State of New York if they had not been taxable.

Where does this difference go? On $200,000,000 a difference of at least, if not more than, 0.25 percent interest each year.

Does it come back to the Treasury from income taxes fixed upon the incomes of the large income group? Are those bonds sold?

Do they find their way into the hands of those people to the extent that even an appreciable amount of that 0.25 or 0.50 difference would come back to the United States Treasury? Certainly not.

Does it go into the hands of the person who buys the bonds for investment?

They pay the additional amount for the security of the United States Government, but it does go into the hands of those middlemen through whom they are purchased, just as the difference in the State bonds, if they were taxable, would go into the hands of the syndicates that bid for those bonds. It is that intermediary step that takes up that amount of difference, so that the individual taxpayer, with the exception of the very few—and that is constantly diminishing—that

could benefit by it, and the Treasury of either the State or the Nation does not benefit by it.

Senator TAFT. Have you any figures to show the commission on taxable bonds and the figures to show the commission on nontaxable bonds?

Mr. EPSTEIN. No, sir; I haven't, but I can show you this specific example of what happened in New York State: They had a little issue, when they were building this new Peace Bridge, when the bridge fell down across the Niagara River from New York to Canada—the ice crushed it.

A Federal commission was created and the State of New York agreed to furnish the approaches to the bridge at $300,000, to the construction of it.

This Federal Commission was floating a 3-million-dollar issue to finance that bridge—it was to be taxable—and they didn't get a bid in the first two offerings, and they finally had to sell it for 4 percent at a private sale.

Senator TAFT. Then there was something the matter with the bonds.

If that was a fully guaranteed Government bond, and there hadn't been anything the matter with it, they wouldn't require any 4 percent.

Mr. EPSTEIN. This was the first experience in selling a taxable issue.

This took place 4 years ago. The effect was that terriffic increase.

Senator TAFT. There must have been something else in it. You would certainly have to give pretty good evidence here to support the claim that in some way underwriters take down a bigger percent of taxable bonds than nontaxable bonds.

Mr. EPSTEIN. We are not talking of underwriters' commissions. But this much you will admit, Senator: Certainly the difference between the additional amount that the Federal Government has to pay, or that any government would have to pay, for the taxable issue, does not come back in the form of income taxes.

Senator TAFT. I wouldn't admit anything of the kind.

Mr. EPSTEIN. You can't have it both ways.

Senator TAFT. If the State of New York can sell bonds for 1.72, when the Federal Government is paying 2, why, the reason that it is worth that much more to somebody to escape taxes, and there is no way to get that from that.

Mr. EPSTEIN. I beg to differ with you. It isn't because they seek to escape taxes.

Even if it were, the Federal Government still can't get it back in the income taxes, because all you have to do is to look where the tax-exempt bonds lie.

You are not going to get it back from your sinking funds, from your public funds, that are elsewhere.

Senator TAFT. You will get back the difference between the rates because people pay for bonds what they are worth to them, and they are worth to them more only because they are not taxable.

Mr. EPSTEIN. Not at all; I wish you would give some time to the study of the economic brief which we presented 2 years ago.

Senator TAFT. I may say that all the witnesses have admitted that the thing is approximately equal; that you will get back in taxes about what it will cost the local government.

Mr. EPSTEIN. I do not concede that, because the facts of the holdings of bonds and where they exist proves quite the contrary.

Now, I would like to address myself——

Senator TAFT (interposing). I might state it isn't only estates. Banks profit by the nontaxable feature. We just had the city of Detroit.

Also banks, more today than they were. They haven't been paying any taxes, but now it makes quite a difference to them whether they are nontaxable or not.

Mr. EPSTEIN. If you will analyze the holdings of tax-exempt securities everywhere in the United States, and the sources from which you could derive income-tax revenues from those sources, you will be convinced that you could not get back even a substantial percentage of it.

Senator TAFT. No; because a market is a market, and if somebody pays more for municipal bonds it is because they are worth that much more to them, and the only reason they are worth more is because they don't have to pay taxes which they otherwise would pay.

Mr. EPSTEIN. But it doesn't follow that the price or interest differential would come back to the Treasury in the form of income taxes. There is a wide gap between what appeals to the general public, in whatever form, and that which you can reach through income taxes.

Senator Connally asked a question this morning of Dr. Lutz, with regard to the question of States entering various business activities, and the borrowing by the States for the purpose of financing those activities, and with the possibility that that might be an avenue of entry by States into activities and thereby escape taxation.

The complete answer to Senator Connally's suggestion is found in the South Carolina liquor tax case, where the Supreme Court held unequivocally that the States could not dry up regular available sources of Federal taxation by entering those fields of activity.

The businesses could be taxed where they enter businesses that otherwise are available as fields for Federal taxation, and could not, by the entering into those businesses, pull them out of the normal field of Federal taxation, but there is no holding that, where the State actually borrows on its own credit, to finance an enterprise, that the Federal Government has the right to come in and place a direct burden upon that method of State financing.

The courts have shifted from the theory of exempting from the tax because of the point of incidence of the tax to the basic principle that you may not tax either Federal or State reciprocally where you impose a burden on the borrowing power of that Federal coequal sovereignty of our set-up.

In *Rogers* v. *The State of New York*, the Supreme Court unanimously held that New York State couldn't tax the salary of the general counsel to the Panama Railroad, because it was a Federal agency.

The incidence of the tax was upon an employee of the Federal Government, and therefore it was not held taxable. Within 2 years the Supreme Court reversed itself. It was my privilege to argue the *O'Keefe case—O'Keefe* v. *Graves*—in which the State of New York sought to impose its income tax upon an employee of the Home Owners' Loan Corporation, and there, with Mr. Justice Stone writing the opinion, the Supreme Court held that the *Rogers case* was wrong, and all the cases of that line were overruled, that here you were not

placing any additional burden upon either the Home Owners' Loan Corporation, or conversely upon the State of New York, in taxing an employee of the State of New York with Federal income taxes, because there was no corresponding indication that the burden had to be borne, in that increased amount, by the State or by the Federal employer.

There is no indication that there has been any corresponding increase in the wages or salaries paid to those officials or employees.

The incidence of the burden there was upon the citizen himself, but the Court had clearly in its mind other possibilities when it pointed out the distinction in the case, where you place a burden upon the borrowing power of a State or its municipal subdivision, which inevitably follows, and cannot be denied, and is conceded by the Treasury, when you place a tax upon the income from the securities you place a burden upon the borrowing power itself, and stripped of all its surrounding circumstances we come here to a basic issue in our political structure.

No one would have guessed, some 5 or 6 years ago, that if the President of the United States should be able to name seven of the nine members of the Supreme Court that you wouldn't have eliminated that so-called no man's land, where one vote would decide critical cases; yet we know, from the experience of the last 3 or 4 years, and the experience of this year, that you cannot eliminate the human element, and you cannot eliminate the operation of the minds that differ, and you still have the difference of one vote deciding critical issues, and therefore the people of the United States—represented in their local communities, in their States, their cities, their towns, and their villages—have a right to expect above all that the Senate of the United States, constituted as it is, and the Congress of the United States have as important a voice in determining the constitutional issues as the Supreme Court of the United States, because theirs is the responsibility, in the first place, to determine whether the legislation shall be passed which, even if presented to the Court and sustained, should endanger the structure, the constitutional structure, the Federal system of the United States, and it is that to which I wish to address myself very briefly.

Democracy is just like sacred charity. The States, the counties, the cities, the towns, and the villages of this Nation, grown great through that faith in and the practice of democracy in those very communities, face in this issue before this body a direct threat to their independence, and may I state that that threat is political as well as fiscal.

You cannot function with political independence, when your very sources of economic integrity are in jeopardy, and that is what is involved in this issue of taxing State and municipal securities.

There cannot be the slightest pretense any longer, on the side of the Treasury, that substantial revenues are expected from this issue which is now before this committee.

None can be forthcoming in substantial measure for at least a generation.

We are in a war to preserve the last vestige of the democratic way of life upon this sad earth.

The sinews of war are men, material, ships, and guns. These cannot be produced from fiction. They need revenues—money.

This is no time, Senators, for indulging in debates on the academics of what shall be the future of local financing. Since revenues cannot

be produced from this suggested source of the future taxation of State and local securities, this is no time for including it in a wartime revenue bill.

There is time enough to bother the people and the municipalities about it when this war will have passed.

The Conference on State Defense, which I have the honor of representing, has never objected to but has urged that this issue be placed before the American people, in the form of a constitutional amendment.

Let the people of the States decide the issue, after a full and fair discussion, and not have it injected, as was tried a year or so ago, at th tail end of some other measure but was defeated after full and fair debate on the floor of the Senate of the United States.

We ask this body to reject the Treasury's suggestion, and leave the States and the municipalities of this great Nation to fight the good fight of political as well as fiscal democracy and independence, as they have done for 150 years thus far—and with a fair degree of success, we submit.

Democracy and the independent political life of 140,000,000 people cannot exist in a Nation which is governed exclusively in all matters from Washington.

From the days of the heroic little Greek city states and until this very day it is a truth still unassailable: The democratic government must have a local habitat.

When democracy, in the State and the city and the town and in the village and hamlet, dies, then democracy in the Nation itself is bound to perish, and democracy in the States and cities and towns and villages of this Nation cannot survive without fiscal as well as political independence.

That independence the Treasury Department now wishes to destroy.

Here before this great committee of the Senate of the United States, in whose halls the spirits of Webster and Clay and Calhoun and Borah still sit and listen, the representatives of the States and the cities and the towns and the villages of this Nation, represented by their Conference on State Defense, make this earnest plea to this committee: To kill this wicked measure.

Senator BAILEY. All that you have said is very eloquent and I am somewhat in sympathy with it, but isn't this the question:

The local cities and States which are the foundation, you said, of the springs of the general democracy, have formed the habit of coming to the Federal Government with their relief problems. They cannot retrace their steps. Isn't it the habit to call on the Federal Government for so much money?

Mr. EPSTEIN. May I approach that from the opposite angle?

Senator BAILEY. Any way you approach it, I would like to stop it.

Mr. EPSTEIN. So would I. You can stop it in one instance by drying up the source from which they come, and are begged to come, and are invited to come, and you can dry it up in a second degree by permitting them a fiscal independence and not placing a burden upon their borrowing power when they may need it, which will make it more impossible to finance themselves than they could anyway.

Senator BAILEY. The difficulty is they do not seem, themselves, to dare anything for fiscal independence, until you come to some tax proposition on the securities.

They are utterly dependent all the rest of the time, and they beg for everything possible, and they vote that way.

Now, haven't they practically estopped themselves from complaining, if the Government proposes to tax them?

Mr. EPSTEIN. I don't think you can ever estop governmental bodies in this country, or the citizens, from maintaining——

Senator BAILEY. I am not speaking of legal estoppel: I am speaking of moral estoppel.

Mr. EPSTEIN. There is no moral estoppel. Irrespective of however they may have been in a suppliant mood before, from raising a political issue, when that issue exists it is an issue that overrides whatever may have been the results of either the invitation or the begging tactics that have been pursued heretofore.

Senator BAILEY. You are from New York City?

Mr. EPSTEIN. I live in New York; I work in Albany.

Senator BAILEY. Now, could you possibly estop New York City from calling on us for a billion dollars a year?

Mr. EPSTEIN. Could we?

Senator BAILEY. Yes.

Mr. EPSTEIN. That involves perhaps a dissertation upon political matters germane only to New York City. I think a great deal could be done.

Senator BAILEY. Isn't that where your democracy has dried up?

Mr. EPSTEIN. I don't think that that necessarily is the basic——

Senator BAILEY (interposing). New York will do anything which the administration says, because if it doesn't it doesn't get the money.

Mr. EPSTEIN. There are many other reasons, Senator, for that.

Senator TAFT. Mr. Epstein, let me call your attention to one inconsistency in the same thing:

The National Educational Association just filed a brief against this taxation.

They are actively supporting a bill on the calendar of the Senate to get $300,000,000 distributed through the various states to maintain the common schools.

Don't you think this is an inconsistent position on this question of local independence?

Mr. EPSTEIN. I view with grave concern any attempt to finance or control educational policy from Washington, Senator.

Senator BROWN. Mr. Epstein, I would like to set the record straight on this matter of distribution of State and local tax-exempt bonds:

These figures are rather old—1937—but approximately the same amount of bonds were outstanding then as are outstanding now.

I think Professor Lutz testified 19½.

Mr. EPSTEIN. Something about $20,000,000,000.

Senator BROWN. This was $19,300,000,000, and $4,300,000,000 were in the hands of governments and their agencies, trust funds and so on, where the tax-exempt feature was of no particular benefit.

In the hands of banks approximately $3,000,000,000; insurance companies approximately $2,000,000,000.

I will state that again:

Governments and their agencies, $4,300,000,000; banks, excluding mutual savings, approximately $3,000,000,000; insurance companies just under $2,000,000,000; other corporations $800,000,000; and individuals $8,300,000,000.

I was inclined, after some considerable study that I made at that time, to believe that the estimates of the Treasury were reasonably accurate at that time.

They showed the basis for their estimates, and it seemed to me, and to the other members of the committee, that if that is a fact, what you said in the earlier part of your statement, that doesn't seem to me to comport with the facts. There are approximately $14,000,000,000 in tax-exempt bonds where the tax-exempt privilege is of material benefit to the holder.

Mr. EPSTEIN. Would you let me give you a mathematical answer to that?

Senator BROWN. Yes.

Mr. EPSTEIN. Let us take the entire $20,000,000,000 of State and municipal issues that are not taxable, that are now outstanding, place, them at 3 percent, as a fair average. That is, interest at $600,000,000 a year. Of that $600,000,000 a year—that is the total interest assuming that you could reach, actually reach, 50 percent or $300,000,000, by income taxes, at what rate would you be able to tax this—in what brackets?

Assuming you average 30 percent—that is a pretty high bracket; that gives you $90,000,000 a year return, on the basis of taxing on $20,000,000,000 one-half of the entire interest at a taxable rate of 30 percent. That is a straight, simple, mathematical calculation, which I respectfully submit defies and answers every one of the purported Treasury figures.

Now, just take the total figures themselves and figure them up:

Twenty billion dollars at 3-percent tax exempt is $600,000,000 a year.

If you can reach 50 percent of that you reach $300,000,000 a year.

If you reach it in a 30-percent bracket you reach $90,000,000 a year which you get to the United States Treasury.

Figure it any way you will, I don't see how you can do better than that.

Senator GUFFEY. Does that answer Senator Brown's statement that $8,000,000,000 were in the hands of people who got some benefit from tax-exempt securities?

Mr. EPSTEIN. That would allow $10,000,000,000 to be in the hands of those people.

I respectfully submit that that is an answer.

Senator BAILEY. Let me get before you just one other thing: The States and counties and cities leaning on the Federal Government have been enabled, in a great many instances, to reduce their taxes on real property, the direct taxes which the Federal Government can't tax.

Now, the Federal Government must have some way to get even. On these securities the State has to pay a high rate of interest or sell the bonds at a high premium. That goes back then on the real property, the direct tax.

Isn't that situation created by the States and counties and cities themselves?

Haven't they steered themselves into just this situation?

Mr. EPSTEIN. Senator, I am not concerned with how they steered themselves into it.

I am concerned with stopping what I consider to be a dangerous trend in one of the basic fundamental structures—foundations of our national structure.

Senator BAILEY. I think the trend is one that takes its origin in the counties and cities and States, and you think it takes its origin in the Treasury.

Mr. EPSTEIN. We can probably debate where it takes its origin, but I think we should attempt, irrespective of how it obtained its origin, to put a stop to it if you can.

What I am concerned with is stopping a measure in the Congress of the United States which will undermine a basic part of our Federal structure, and this will do it.

Senator BAILEY. If the localities and the States and the cities will not call upon the Federal Government, I will go along with you and not tax their bonds, but as long as they call on us for all we have got—and more besides—there has got to be some compensation somewhere.

Mr. EPSTEIN. I don't know just whether the dog wags the tail or whether the tail wags the dog.

Senator HERRING. I think this is a good place to start, because New York City is one of the cities that has been taking hundreds of millions of dollars out of the Federal Treasury, where the other cities and towns have been pulling up 40 and 50 percent.

Mr. EPSTEIN. I am not prepared, because I don't know what the figures are or what New York City puts up as a sponsor.

May I suggest that what the Federal Government derives from New York City may, perhaps, be adequate explanation of what New York City gets from the Federal Government.

Senator HERRING. I think they take it away from us.

The CHAIRMAN. Thank you.

Mr. TOBIN. Thank you for your hearing that you have given the States and cities. We appreciate very much the time you have given us.

The CHAIRMAN. All right, Mr. Tobin. We appreciate your services to the committee.

Mr. Levine?

STATEMENT OF LEONARD LEVINE, NEW YORK, N. Y., ON BEHALF OF THE ASSOCIATION OF COMMERCIAL DISCOUNT COMPANIES

Mr. LEVINE. I am appearing here on behalf of the Association of Commercial Discount Companies, for the purpose of obtaining an exception for finance companies and factors from section 501 (b) of the Internal Revenue Code.

The CHAIRMAN. Did the House bill deal with that section, Mr. Levine?

Mr. LEVINE. The House bill dealt with that section, and they granted an exception for loan and investment companies, which did not include companies of our character.

This provision was dealt with in section 182 (b) (7) of the House bill and was mentioned in the Ways and Means Committee report, item III-6.

The exception that the Treasury Department recommended, and that the Ways and Means Committee report took up and has car-

ried through into the bill, was for loan and investment companies subject to the supervision of State authority. The Treasury did not consider that these companies are of the type that would desire to be reached by the personal holding company tax.

The financing companies and factors, of which the Association of Commercial Discount Companies, having 33 members, with a combined capital of approximately $5,000,000, and employing approximately 500 employees, whose activities involve the financing of approximately 1,500 to 2,000 companies, doing an annual business of one hundred and twenty-five to one hundred and fifty million dollars, who, employing somewhere between one hundred and one hundred and fifty thousand people, have found themselves in the position of being caught under the provisions of the Personal Holding Company Act.

The Personal Holding Company Act has provided an exception for banks, life-insurance companies and surety companies. After hearings a few years ago Congress finally exempted licensed personal finance companies, and have since seen fit to put in an exemption for loan and investment companies in the present bill.

It is our contention that, when the Personal Holding Company Act was first put into law, that the original intention was to reach incorporated pocketbooks.

We do not believe that it was ever the intention of the makers of the law at that time to have included companies that are actually operating companies, and operating the same as our companies are today.

However, because of the fact that the law provides that where 80 percent of the income is classified as interest in a company, and where the company has 50 percent in value of the outstanding stock owned directly or indirectly for not more than five individuals, those companies are to be included under the provisions of the Personal Holding Company Act.

The result has been that the Treasury Department has been classifying companies of this particular type under this section of the law, and that the courts have been upholding their decisions.

Now, I might point out that financing companies and factors actually operate on a business basis, in that they purchase accounts receivable, with or without recourse, make advances to business concerns, factor sales, check credits, factor inventories, guarantee purchases, makes loans on machinery and equipment, and perform all of the customary functions of a commercial finance company and factor.

Furthermore, they go beyond that particular point, and they even help in many cases to supervise the businesses, assist the concerns in their costs and production methods.

Now, it must be remembered that the companies that find it necessary to avail themselves of the use of the financing companies and factors are very small business concerns.

They are concerns that find it impossible to obtain the necessary credit in regular banking channels, or through other sources, and most of these concerns, without the aid and assistance of the financing companies and factors would find it impossible to continue in business.

At the present time, because of priorities and the changing nature of business in general, many of these concerns have found it neces-

sary to switch their activities from the ordinary commercial pursuits to war production.

In most cases these concerns have nothing but a plant and equipment. If you look at their balance sheets you will find that they have no working capital and it would be impossible for them to continue in business without aid of this kind, and they again, as I say, find it impossible to get sufficient aid in regular banking channels.

That means that the financing companies and factors today are fulfilling a very important need in the financial community, and in the business world, by helping these concerns stay in business.

It must be recognized that they are taking unusual risks in helping to finance these companies.

It must be remembered that there are plenty of these small concerns, who before they get started or get to learn the know-how of the work in some of these Government orders, find themselves in the red, and again, without the cooperation, aid, and assistance of these financing companies and factors, might find themselves out of business.

I think it is recognized that it is important to try to keep these small concerns in business—the middle class, as we might call them—and try to help them continue on and to perform the type of work that they really can perform, in connection with the war production.

Now, in taking the unusual risks that we are taking, it is necessary for the financing companies and factors to build up some reserves.

With the present high rates of normal and excess-profits taxes there is not going to be such a large amount of money available and left, even if you exempt these companies from the provisions of the personal-holding-company section of the act, to be put into these reserves, but even at that it is important that they be enabled to take and accumulate that additional amount rather than finding themselves in the position where it is necessary for them to declare out as dividends, on a consent dividend basis, all of their earnings, in order to escape the personal-holding-company taxes.

Now, when we realize the losses that were taken after the last war, and the losses that were taken after the depression, we can realize the losses that will be taken when this war is concluded and the financing companies and factors, financing really the weakest group of companies in the industrial world today, are definitely going to take the largest losses.

I might just point out a few figures, as quoted with respect to the commercial and industrial failures in the United States:

In 1918 there were 9,982 failures, with liabilities of $163,000,000.

In 1921, after the war, when the real repercussion took place, there were 19,652 failures, with total liabilities of $627,401,000, which was the largest amount in failures recorded since this table was prepared in 1895.

In 1922 you had 23,676 failures, with total liabilities of $623,895,000, and again in 1932 you had 31,822 failures, with liabilities of $928,313,000.

Incidentally, they list these liabilities as current liabilities, so there must have been other fixed obligations in addition to this amount.

Now, our companies are going to get the kick-back after the war on a very serious basis, and I feel that it is necessary to provide this

exception for these companies, so that they may be able to have the necessary reserve after the war is over.

Senator TAFT. I missed the question as to why section 7 doesn't cover it.

Mr. LEVINE. Which section?

Senator TAFT. Section 7 in the House bill.

Mr. LEVINE. Because that section just pertains to loan or investment companies subject to the supervision of State authority, having supervision over the financial institutions.

Now, those institutions are mainly institutions along the line of the Morris Plan, which I believe is familiar to most of you Senators, and actually provide loans up to $5,000.

Senator TAFT. You mean you are not subject to State authority in many cases; is that it?

Mr. LEVINE. No, sir; we operate under charters from the different States. We are granted charters to do business as regular business corporations, but the State has never seen fit to subject us to State authority, because of the fact that we do not receive deposit funds or sell certificates of indebtedness, or perform any of the other types of activities that are carried on by these loan or investment corporations.

These loan or investment corporations are largely an enlarged form of the licensed personal-finance companies, which were originally sponsored by the Russell Sage Foundation. They really pertain mostly to what I would call the small—very, very small—individual business, that would require up to $5,000.

On the other hand, I might point out that our companies might take and finance companies to the extent of three or four or five hundred thousand dollars.

Senator TAFT. What is the difference in tax to you one way or the other?

Mr. LEVINE. With these new rates it is pretty hard to figure out.

The personal-holding-company section of the law, under the new rates——

Senator TAFT (interposing). Eighty-five percent?

Mr. LEVINE (continuing). Will have 85 percent after the first $2,000.

Under the tax structure, if we have a 45 percent normal tax, and an 80 percent excess-profits tax, there may not be any considerable difference, but the fact is that we should never have been subject to this particular section of the law.

In fact, when the law was first written, and for the first few years afterwards, most of these companies did not even know that they were subject to this particular provision. It was only after the Treasury Department found that, by a strict reading of the law, they could bring these companies within the scope of that section of the law.

I might point out just one other thing, and that is that if any of these companies attempt—if it is going to be possible; I don't think it will be—to escape the individual surtaxes by not declaring more dividends, and accumulate more surplus than is necessary in the pursuit of their business, the Treasury Department can deal with it under section 102, which deals with that particular problem.

Senator TAFT. What is the interest rate you charge an industrial corporation?

Mr. LEVINE. The interest rate is 6 percent, and then there is a service charge which these companies make in addition to that, which may run anywhere from a half to 1 percent a month, and that is because of the close supervision they have to give these companies, in which the banks and the other loaning institutions are not willing to indulge.

The banks sit back, even today, and are willing to take loans, where they know they are a hundred percent good, and they do not have to do anything but just put out large sums of money on a 2 percent basis, but they have very little more to do with those loans than just having a single note made out for a certain amount of money.

They don't have to take situations where there is no working capital available—in fact, in most cases, where there is actually a working capital deficiency.

There are plenty of companies that have fine plants, well equipped mills, and just haven't got the working capital to run them.

The CHAIRMAN. Any further questions?

(No response.)

The CHAIRMAN. Anything else?

(No response.)

The CHAIRMAN. Have you ever talked with the Treasury about your problems?

Mr. LEVINE. I have discussed this matter with the Treasury Department, and sent them down a lot of literature and information in connection with it, and I haven't received a definite answer from them yet.

The CHAIRMAN. All you want to do is to get taken out of the definition of a personal holding company? That is what you are really driving at?

Mr. LEVINE. That is correct.

The CHAIRMAN. And the House didn't go quite that far—they didn't include your type of company?

Mr LEVINE. That is correct.

The CHAIRMAN. All right, sir.

Mr. LEVINE. Thank you.

The CHAIRMAN. Thank you very much.

Mr. Hawley?

STATEMENT OF JOHN B. HAWLEY, JR., PRESIDENT OF NORTHERN PUMP CO., MINNEAPOLIS, MINN.

Mr. HAWLEY. Senator George, members of the Finance Committee, I have a copy of this brief, which covers my situation, and I would like permission to read it.

The CHAIRMAN. We are pressed for time. Can you shorten it by stating what is in it?

Mr. HAWLEY. I don't believe so.

The CHAIRMAN. You may proceed.

Mr. HAWLEY. I am here today to present to your committee my views on the 1942 Revenue Act.

The Northern Pump Co. now has direct Navy contracts exceeding $200,000,000.

These contracts are for vitally needed gun mounts and coacting hydraulic equipment.

Our company now has an outstanding production record and was 1 of the group of 14 manufacturers to receive the first Navy "E" award. The company converted to full war production 18 months before Pearl Harbor. This conversion was made although at the time we enjoyed an excellent and profitable commercial business.

I believe this act, as proposed, has features which will prove most detrimental to the production effort of my company and also that it will slow down all war production.

Features of the proposed law which most adversely affect the production and operations of the Northern Pump Co. are:

1. The 90 percent excess-profits tax rate.

2. The provision that the 1942 rate will apply retroactively to the earnings of corporations whose fiscal year started prior to January 1, 1942.

3. The dual taxation effects of this law and the contract renegotiation provisions of Public Law No. 528 of April 28, 1942.

The Revenue Act approved by the House provides for a 45 percent normal tax and a flat 90 percent excess-profits tax applied uniformly to all income in excess of the excess-profits tax credit. Any rate in excess of 80 percent is detrimental to the war effort. Excessive tax rates encourage high-cost operation. When the State and Federal Governments take 90 percent or more of earnings, uneconomical manufacture is encouraged.

These high tax rates penalize small, efficient manufacturers. In the present war effort, a large number of the most efficient manufacturers are small, flexible companies who have been able to get into war production quickly. These companies have taken a volume of orders very much out of proportion to their capital. The orders taken involve an extremely high financial risk. In such instances, an 80 percent top-tax rate is the highest rate under which such manufacturers can operate on a high-risk production basis.

As an illustration, take the case of our company with a small capital and a small excess-profits tax credit. Our excess-profits tax credit is approximately $260,000. We manufacture in a year equipment at a production cost of approximately $50,000,000.

(Discussion had off the record.)

Mr. HAWLEY. If we realize a profit of $6,000,000, we will have, net, after estimated State and Federal taxes with an 80-percent excess-profits-tax rate, an approximate amount of $1,200,000, which amount is 2.4 percent of cost. With a 90-percent rate, we would have a net income of only $600,000, which amount is 1.2 percent of cost.

The normal Federal tax of 45 percent will apply to less than 5 percent of the total earnings or only those earnings resulting from approximately 2 weeks' sales. The remaining 95 percent of earnings is subject to the excess-profits tax.

We manufacture equipment of a type requiring service under guaranty clauses for periods of from 1 to 5 years after delivery; $600,000 is hopelessly inadequate to cover guaranties on such a large volume of business and also inventory devaluation, post-war rehabilitation, and so forth.

In our situation three contingencies are present that should be recognized in adjusting a tax program that fairly will fit the effort we are making:

1. Our products are large, expensive, complicated, intricate pieces of equipment with a multitude of precision parts which are required to function under infinitely difficult conditions. No matter what guaranty we give with these products, it is our duty reasonably to service them for a substantial period of time. Our good name alone requires, if nothing else, that we do this. This means that somewhere included in the earnings realized must be a substantial sum available for these charges. In this respect we differ from the manufacturer of simple items such as pontoons and shell cases and the mass producers of standardized machinery.

2. Our inventory is made up of a great multitude of different items, most of which have only scrap value unless sold on present contracts before change of design and obsolescence. When the inevitable end to this war production arrives, the loss that will exist on our excess inventory is obvious. Fair consideration should be given to this factor.

3. Production of our present work will inevitably "tail-out." During that period the cost of production will rise rapidly. During and following that period there will be the necessity for changing over our plant to the production of peacetime articles. During this interim, while we are in this twilight zone, general expenses will continue, new additional expenses will appear, and income will rapidly dry up. Recognition should be given to the necessity for creation of a reserve out of present earnings which will bear some reasonable relation to these inescapable expenses.

Senator TAFT. May I ask a question?

Mr. HAWLEY. Yes, sir.

Senator TAFT. How will you finance this increase of capacity? You must have increased your capacity very much?

Mr. HAWLEY. Yes, sir; we increased our capacity fiftyfold.

Senator TAFT. How did you finance it?

Mr. HAWLEY. Do you mean recently?

Senator TAFT. Yes; I mean for this war production—contracts exceeding $200,000,000.

Mr. HAWLEY. First we went to the R. F. C. and fiddled around for 3 months and got nothing. Then we called Mr. John Peyton of the local Federal Reserve, and in 24 hours he got us $5,000,000 to keep us from going broke, and after that we got a bond on our contract.

In the meantime I had spent $15,000,000 on my personal credit on the cuff. Is that clear?

Senator TAFT. Do you now owe $20,000,000, or what is your present status?

Mr. HAWLEY. I would state at the present that I owed on Navy advances about $15,000,000, and I owe the local bank nothing because of the readjustment clause, this Public, 528, that is passed. The bank won't loan anything any more, although for the previous 33 years they would lend me the full amount, which is 1 percent of the capital.

Senator TAFT. They figure that you haven't got any contract any more?

Mr. HAWLEY. They figure I don't know my selling price, therefore, it would be difficult to allow what I might be liable to have.

Senator TAFT. Do you owe anything now?

Mr. HAWLEY. The corporation owed me about $300,000 on notes for salary for some time back.

Senator TAFT. What I am trying to get is whether you are going to have a debt after the war that is going to embarrass you or where have you gotten the money to build the additional plant necessary.

Mr. HAWLEY. The Navy advanced the money to build the plant and I put two million——

Senator TAFT. By "Navy advances" you mean just on the contracts?

Mr. HAWLEY. No, sir.

Senator TAFT. When the deliveries are made do you pay that back?

Mr. HAWLEY. They gave me a building contract at cost plus no fee to build the plant, which was about $17,000,000 and I put $2,000,000 of my own in. I own the land and two buildings and the Navy owns two buildings and a lot of machinery, and I own a lot of machinery, and it is all scrambled up.

Senator TAFT. You can give the Navy back the buildings after the war?

Mr. HAWLEY. I have got the first two buildings and they have got the next four. We could draw a line between them and I could operate on the south side with a parking lot and they could put up a parking lot on the north side.

Senator TAFT. I am wondering whether after the war you will be able to cut down your production.

Mr. HAWLEY. It would be impossible for me to answer it at this time because I don't know whether I have any profits or not, due to this Public Law No. 528 which is still under negotiation, and after doing a great deal of business, the details of which I can't mention in open session, I don't know where I stand.

A practical tax program should allow the manufacturer savings for the rainy day which is surely coming.

Faced with a 90-percent excess-profits tax rate, we do not see how we can continue to produce at the same high rate as in the past. Our obvious recourse is to reduce our volume of business to one consistent with our small excess-profits tax credit. That means the money remaining after we pay our excess-profits tax, not knowing what it is, but I do know it will be very little, we must reduce our risk factor consistent with the money that will be remaining. Then the contingencies we face are reduced to a point where they can be met from the earnings left us after taxes. Any such procedure resulting in decreased production is detrimental to the war effort.

The Northern Pump Co. has a fiscal year ending June 30. We budgeted our operations for the fiscal year ended June 30, 1942, on the assumption that our income for that year would be subject to the income and excess-profits tax rates of the Revenue Act of 1941. This assumption was amply justified because all new revenue acts since 1932 have made the new rates applicable only to fiscal years commencing on or after January 1 of the year in which the law became effective. When the new revenue law is not finally determined until several months after the close of our tax year and the rates are made retroactive, we are seriously hurt by the loss of working capital to cover obligations incurred during the year.

(Discussion had off the record.)

Mr. HAWLEY. We are faced with a tax program composed of two parts. One is the Renegotiation of Contracts Act; the other is the 1942 Revenue Act. A fair tax program can be drafted which will

apply only one yardstick, one set of returns, and one body to administer.

The administration of Public, No. 528 has resulted in Price Adjustment Boards being created by the Secretaries of War and Navy and by the Maritime Commission. We have observed the functioning of these Boards and have had contact with the Navy Board. We have been before the Navy Board.

The law requires renegotiation and price adjustment of firm contracts entered into prior to the effective date of the law. This is an abrogation by the United States Government of its contracts and has caused contractors to lose faith in the integrity of all Government contracts. The renegotiation clause in new contracts makes the contract price subject to reduction without contractor's consent. Then production becomes secondary to caution.

It is impossible for the Price Adjustment Boards to apply uniform treatment to all contractors. The entire administration of the law is left to the discretion of the Navy, Army, and Maritime Commission. It is so wide open that contractors are at the mercy of the opinions of a few individuals. No protection is given the contractor against repeated renegotiation. The contractor has no practical right of appeal from the rulings. Federal income-tax rulings are of long standing and are familiar to the contractor.

Present accounting methods adopted by the Boards do not agree with those used by the Treasury Department for income-tax purposes and the contractor is whipsawed between conflicting audits.

The law cannot be administered without discrimination. Discriminatory action must be exercised as to—

1. Time over which contractor's earnings are to be renegotiated.
2. Rate of profit to be allowed in each individual case.
3. Whether profits remaining after renegotiation are subject primarily to normal tax rates or, as in our case, primarily to excess profits tax rates. No consideration whatever is given to income taxes in renegotiation procedure.
4. Whether or not State income taxes are to be considered in renegotiation.

First War Powers Act of 1941 stipulates:

> Nothing herein shall be construed to authorize the use of cost plus a percentage of cost system of contracting.

The boards have uniformly based profits on a percentage of cost which is contrary to the provision of the First War Powers Act. This method results in contractors with fixed price contracts having their profits determined on the basis of a cost plus a percentage of cost. The contract price becomes merely a ceiling. This encourages high costs and penalizes severely the low-cost producer. Costs are a function of production and the low-cost producer is the high-rate producer. Thus the result of basing profits on costs is very definitely to slow down production. Contractors are unwilling to assume heavy obligations to perform Government contracts, knowing that their final profit is left to the discretion of a few individuals.

Under Public, No. 528, the contractor works with peak effort toward efficiency on the first part of a large order until a high profit is in sight, then realizes that any future increase in production will not only result in no profit after renegotiation but also will cause him to

take new contracts at reduced prices and attendant higher risk factors.

The result of Public, No. 528, is to place taxing power over all profits in the hands of a few individuals. This power should be retained by Congress.

Both the revenue act and the renegotiation law are means of taxing the same corporate income. After contracts have been performed and earnings determined, any excess profits can be recovered by excess-profits tax alone. This fact has been previously recognized by Congress in its action in suspending the profit limitation provision of the Vinson-Trammel Act in the Revenue Act of 1940.

In the interest of maximum production, corporate management should not be unduly burdened with problems concerning overextended financial risks, renegotiation of firm contracts, and continuous audits which divert attention from the real job of production. Legislative action having retroactive effects and which leads to abrogation of firm contracts leads the manufacturer to believe that other drastic changes in the rules may be forthcoming. Thus he is willing to make only short-term commitments and take contracts for small quantities of material. This reduces possible savings resulting from mass production. He is no longer in a position to "jump the gun" and start work on projects prior to receipt of formal contracts, as future earnings are completely unknown and no longer within his control.

We are proceeding with production at full speed as in the past, hoping against hope that taxes will leave us in a financial position to continue operating with maximum efficiency and greatest possible output in the best interest of the war effort. To permit this will require:

1. An excess-profit tax rate of not greater than 80 percent.
2. Elimination of the retroactive feature of the proposed revenue act.
3. Repeal of Public, 528, regarding contract renegotiation.

Thank you.

The CHAIRMAN. Thank you very much.

Any questions?

(No response.)

The CHAIRMAN. Does any member of the committee wish to ask Mr. Hawley any questions?

(No response.)

The CHAIRMAN. Thank you very much, sir.

Mr. HAWLEY. Thank you, sir.

The CHAIRMAN. Mr. W. B. Henderson.

STATEMENT OF WILLIAM B. HENDERSON, WASHINGTON, D. C., EXECUTIVE VICE PRESIDENT, AIR CONDITIONING AND REFRIGERATING MACHINERY ASSOCIATION, INC.

Mr. HENDERSON. Gentlemen, on behalf of the Air Conditioning and Refrigerating Machinery Association, we beg leave to submit the following: First, that we are not trying to avoid taxation, because we realize that to win this war and to minimize inflation that even more taxes are necessary.

We feel our suggestion is a fair one through which, if adopted, the Government will save money and reduce diversion of personnel; also

our industry will be permitted to save much wasted effort and get on with the job of producing goods for the Army and the Navy and the industry, in general.

Most of our industry's business is now in direct war work. We should be allowed to devote our energies to effective production instead of useless paper work.

Our problem has to do with section 3405 of the Internal Revenue Code which formerly taxed only self-contained household and small store-type refrigerators and equipment. In 1941, however, section 3405 was amended to bring into the field of existing taxation many components of industrial and commercial refrigeration and air-conditioning systems and also self-contained air conditioners.

The phraseology of the amended section, as it refers to industrial and commercial components, is ambiguous. Under the present wording of the section, it would be difficult, and in some cases impossible, adequately to define what are taxable components. On many questions, the Bureau of Internal Revenue has been unable to give us clear rulings.

We are faced with endless questions from customers and from the Bureau of Internal Revenue, with litigation, and with years of holding in abeyance sums of money, payment of which is in question.

The sale of industrial and commercial refrigerating and air-conditioning equipment is now almost solely for war effort, generally for use by the Army, the Navy, the Maritime Commission, and other Government agencies.

The CHAIRMAN. You don't pay any taxes on that?

Mr. HENDERSON. One of our troubles, Mr. Chairman, is the work of getting exemption certificates. We wouldn't mind paying the taxes if we only knew what we could pay them on and could avoid all this terrific paper work. It is a tremendous burden that is bowing us down, as I will point out further in my presentation.

The CHAIRMAN. All right. I was wondering how that is a tax problem.

Mr. HENDERSON. There will be comparatively little tax return to the Government during the war. The excise tax return from household, industrial, and commercial refrigerating and air-conditioning equipment has dwindled from $1,460,569 in November 1941, $828,074 in June 1942.

From now on, the tax return can hardly equal the cost to the Government represented by the vast amount of paper work required for exemption certificate procedure, and other similar matters, which must be carried out by the many Government purchasing offices throughout the country. This waste brings no profit to anyone.

We propose the following amendment of section 3405. As you gentlemen will note in the copies which you have before you, the words in the present statute which are to be deleted are stricken through; words which are to be added are stated in italics:

SEC. 3405. TAX ON REFRIGERATORS, REFRIGERATING APPARATUS, AND AIR CONDITIONERS—

There shall be imposed on the following articles (including in each case parts or accessories therefor sold on or in connection with the sale thereof) sold by the

manufacturer, producer, or importer a tax equivalent to 10 per centum of the price for which so sold:

(a) Refrigerators, etc.—Refrigerators, beverage coolers, ice cream cabinets, water coolers, food and beverage display cases, food and beverage storage cabinets, ice making ~~machines~~ *cabinets*, and milk cooler cabinets, each such article ~~having, or~~ *being of the self-contained type* ~~being primarily designed for use with, a mechanical refrigerating unit~~ operated by electricity, gas, kerosene, or gasoline.

(b) ~~Refrigerating Apparatus.—Compressors, condensers, evaporators, expansion units, absorbers, and controls, for, or suitable for use as part of, or with, a refrigerating plant, refrigerating system, refrigerating equipment or unit, or any of the articles enumerated in subsection~~ (a).

(c) Air conditioners.—Self-contained air-conditioning units.

(d) ~~Components.—Cabinets, compressors, condensers, fans, blowers, heating coils, cooling coils, filters, humidifiers, and controls, for, or suitable for use as part of, or with, any of the articles enumerated in subsection~~ (c).

The above amendment would confine the tax to the self-contained type of equipment. This would eliminate the industrial equipment which is the portion involving the ambiguities, some of which are impossible to clarify, but would not eliminate any revenue profitable to the Government.

As to the reasons for change, as the statute stands at present, the tax is impossible accurately to determine, expensive to collect, and uneconomic in its net yield to the Government.

Our proposals arise primarily as a result of our actual everyday experience with the difficulties and expense of interpreting, applying, and accounting for that part of the present tax which applies to commercial and industrial refrigerating and air-conditioning equipment.

We have no means of determining the cost to the Bureau of Internal Revenue of administering this tax on commercial and industrial refrigerating and air-conditioning equipment, but we know the cost must be high. Already it has been necessary for the Bureau to exchange with this association a large volume of correspondence respecting rulings on the application of the tax to different circumstances. Between 20 and 30 oral conferences with the Bureau have been required as a part of such inquiries. Some of these conferences have consumed an entire day. These figures do not take into account inquiries and contacts with the Bureau which have been required of the individual member-companies of this association or of the industry as a whole.

The resulting amounts of time and study required of the Bureau's policy-making and administrative officers have been very great. The difficulties and disputes which may be expected to arise in the future, from an audit of the returns, are calculated to be even more frequent and more consuming of time and thought.

One of the most serious costs in the administration of section 3405 arises from the exemption certificate which is required when the equipment sold is for the use of a Government agency. These certificates are made out by a number of persons who often have little or no knowledge of the requirements for the issuing of such certificates. Because such persons are inexperienced in this type of paper work, protracted delays result before the certificates are issued and the equipment, much of which is in very urgent demand, can be delivered. The difficulties, complications, and delays are particularly acute where, as is most usually the case, the sale is not made directly to the governmental agency, but is made through an intermediate contractor or series of subcontractors. The time lost by suppliers, installers, and Govern-

ment employees who should be devoting themselves to productive effort is substantial.

It should hardly be necessary to add that the time, effort, and attention required do not aid the war effort, nor produce revenue for the Treasury. The endless detail and discussion are an economic waste to the producer, to the consumer, and to the Government.

Typifying the many difficulties inherent in determining whether a tax attaches to a given sale is the phrase "ice-making machine" used in subsection (a) of section 3405, and I may interject there, Mr. Chairman, that this is typical of almost hundreds of cases of our equipment being applied to this section 3405. The question is what is an ice-making machine?

Senator BROWN. Do you have any differences with the Treasury as to the general policy? Are you concerned solely with the technical language?

Mr. HENDERSON. That is exactly it.

Senator BROWN. It seems to me you ought to be able to work that out with the Treasury.

Mr. HENDERSON. Unfortunately, it doesn't seem to be quite that simple, Senator Brown. The Treasury is looking to you gentlemen to write the law. I know Mr. Colin Stam is fully conversant with the technical difficulties involved, and I am sure his advice—I know his advice—is invaluable to you gentlemen. If we could know on what we should pay the tax, if we could have all this paper work taken off our shoulders—and, believe me, it is very considerable—why, then, we would be satisfied.

We are not objecting to paying taxes, but we are objecting to the uneconomic way of going about it.

On this matter of the ice-making machine just mentioned, which is typical of some of our problems, it is hard to describe what is an ice-making machine. Is it something self-contained in the cabinet like a household refrigerator or is it the whole manufacturing plant making artificial ice? There is that large difference in that one little phrase.

If the term "ice-making machine" does not cover an entire manufacturing plant, just what part does it cover? How are questions such as these to be decided without dispute and, where the amount involved warrants, litigation? The situation could not be better illustrated than by the following sentence taken from a letter dated November 28, 1941, sent to our association's counsel by the Deputy Commissioner of Internal Revenue, reading:

> The term "ice-making machines" is not susceptible of general definition. However, rulings will be issued with respect to the taxability of any ice-making machine upon receipt of a description of the article.

Obviously the Bureau is unable to escape the necessity of innumerable individual rulings in instances such as the foregoing.

Another difficulty is ascertaining what items are taxable or how much the tax should be when taxing an assembly of parts, as distinguished from taxing a recognized unit or "package."

Most of our installations—the vast majority of them—are a large assembly of parts such as cold-storage warehouses or factories making artificial rubber or things of that sort. In many cases, only one item in a large assembly of parts may be taxable. Inasmuch as the entire assembly, however, is sold for a lump sum, it is necessary, if

the percentage tax is to be computed for the one item, to assign to that item an arbitrary proportion of the sales price of the entire assembly. In this process, differences of opinion may and do arise. Disputes are to be expected and, where the amounts involved are substantial, the disputes will be prolonged.

So long as this tax remains in its present form, there is no escape from the administrative problems which the foregoing examples illustrate.

Against the expense already demonstrated and the greater expense to be expected in the future, for both Government and taxpayer, the receipts, including those from household refrigerators, from the tax for the first 8 months should be considered. The receipts are approximately as follows:

November 1941	$1,460,569	March 1942	$1,578,922
December 1941	1,606,145	April 1942	1,272,497
January 1942	1,503,134	May 1942	1,014,684
February 1942	1,604,144	June 1942	828,074

It will be observed that the receipts from this tax, under the conditions obtaining in the first 8 months of its application, were relatively small and are growing smaller.

Revenue to the Government from these sources can be expected to become less and less each month, and probably almost stop, as sales for non-war-effort uses are increasingly restricted.

As I mentioned earlier, the receipts from the operation of this tax are dwindling steadily. Last month, or, rather, in June, the amount of tax was only $828,000 and it is my personal opinion that a very large proportion of that $800,000 is represented by exemption certificates on which provisional payment has been made and on which reimbursement will be asked by the taxpayer.

At the present time, of the industry's output of commercial and industrial refrigerating and air-conditioning equipment, more than 98 percent, by dollar value, is sold on a high priority basis. Much of this sales volume is represented by direct purchasing by the Army, Navy, and Marine Corps and by sales for the use of the Maritime Commission, Defense Plant Corporation, Lend-Lease Administration, and other Government agencies having primarily to do with the prosecution of the war. The present tax revenues to the Government from the operation of section 3405 of the Internal Revenue Code not only are diminishing but probably will virtually disappear.

However, in making returns, keeping records, and deciding upon the taxability of given items, there will be continued heavy expense and diversion of personnel—both by the Government and by industry.

Even if there is no tax paid, the paper work will continue and there will be that continued diversion of personnel both by the Government and industry.

If the system of selective excise taxes is to be continued, then substantial changes should be made in the principles upon which the present statute rests. In the first place, the system should be based upon taxable units which are simple to ascertain and which permit of ready agreement between administrator and taxpayer as to their taxability. A self-contained unit, readily discernible and commonly accepted as a unit, is the requisite element in any tax on the sale of articles. That is a point we particularly wanted to bring out. If it

were a self-contained readily discernible article, there would be no question, no difficulty whatever as to its taxability.

We have pointed out how difficult it is, even where it is agreed that an article is taxable, to allocate a part of the sales price to that article when the article is part of an assembly and not a packaged unit in itself.

In the second place, the article to be taxed should be defined in terms which avoid, so far as possible, a reference to the use which is to be made of the article, and that is one of the very difficult points, Mr. Chairman; the use feature in this section 3405. As soon as the question of use enters into the determination, if the article taxed has a variety of commercial uses outside the field upon which the excise tax is to apply, administrative difficulties and disputes are inevitable.

The use of the phrase "for, or suitable for, use as part of, or with," appearing in subsection (b) of section 3405, frequently causes dispute with respect to a given article and results in taxing an article which isn't intended for use and isn't used in the field of industry to which the tax applies.

Senator GERRY. In discussing this matter with the Treasury Department, did you suggest any language which you thought might be useful in clarifying it?

Mr. HENDERSON. They found it as difficult as ourselves in interpreting or getting phraseology to accurately describe these assemblies of equipment.

Senator GERRY. Did you make any suggestions to them as to phraseology?

Mr. HENDERSON. The only thing we could finally come to is the amendment proposed in this brief. We are in a peculiarly complicated field, and much of the stuff that goes into one of the assemblies of our machines can be used in another field as well as not—for example in the heating field, as opposed to the refrigerating field.

Senator VANDENBERG. Would the general sales tax simplify your problem?

Mr. HENDERSON. Very much so.

The CHAIRMAN. It would simplify mine, too.

Mr. HENDERSON. Does that cover the point, Senator Gerry?

Right along that same point, if, for instance, Congress intended to tax pipe coil when used in the refrigerating and air-conditioning industry, it seems grossly unfair to tax pipe coil which was intended for and was actually used in a heating plant unrelated to refrigeration or air conditioning. Disputes as to "suitable for use" are unavoidable. Quarrels arise among buyers and sellers as to which articles are taxable and as to which sales require a tax to be collected, deducted, or withheld. If the amounts involved warrant the contest, litigation follows. I might say that that is quite frequent, sometimes between sellers and buyers, but more frequently between the Government and the party to the sales transaction which is believed to be responsible for payment of the tax. Funds may have to be held in escrow for years. The economy, both public and private, suffers.

In the past, attempts have been made to narrow the field of dispute respecting "use" by putting the test on the design of the article involved—that is, taxing only that article which is primarily designed

for a given use. Then the test as to the tax liability of an article is whether it is designed for the single taxable use or whether it also has a commonly accepted use in fields other than that upon which the tax is levied.[1] Heretofore the difficulty with such a standard has been that, in many instances, the administrators have been loath to admit that the article in question had a variety of commercial uses beyond use in the field to which the tax applied. The consequence has been litigation as to what the fact might be. Wherever the tax rests ultimately upon the use for which an article is suitable, designed, adapted, or intended, administrative difficulties and "headaches" may be expected.

The proposed amendment would cure the above-mentioned difficulties.

In passing, we wish to mention that at present no other types of industrial machinery, no matter how unessential they may be to the war effort, are subject to excise tax. We are, however, making no special point of this discrimination against refrigerating and air conditioning equipment.

Because of the principles just explained, there should be eliminated from subsection (a) of section 3405 all reference to the use for which the articles taxed are designed. Also, if "ice-making machine" were changed to "ice-making cabinet," the term would refer to a "packaged" entity, identifiable as such, and not to a mere machinery assembly or plant. We, therefore, propose that subsection (a) be amended to read:

(a) Refrigerators, etc.: Refrigerators, beverage coolers, ice cream cabinets, water coolers, food and beverage display cases, food and beverage storage cabinets, ice-making cabinets, and milk cooler cabinets, each such article being of the self-contained type operated by electricity, gas, kerosene, or gasoline.

Because virtually all of the equipment subjected to tax under subsections (b) and (d) of section 3405 has commonly accepted uses in other mechanical fields it would be exceeding difficult to levy any excise tax upon such equipment without resting that tax on a definition which involved the use to be made of the equipment. And that covers the point, Senator Gerry, that we discussed a few moments ago.

It is for this reason that we have been unable to develop any satisfactory amendment to these parts of section 3405 which would permit of the taxation of such equipment without encountering the administrative difficulties existent under the present statute. We therefore propose that these two sections of the statute be eliminated.

Subsection (c) we recommend to leave as is, for the articles described are self-contained, and there is no difficulty in determining what is meant.

The foregoing amendments suggested would result in no net loss of revenue to the Government. The small reduction in actual tax receipts would be more than offset by the over-all reduction in cost of administration throughout the various departments, including Government purchasing departments.

As far as the refrigerating and air-conditioning-machinery industry is concerned, it can be said with conviction that a general tax on

[1] See the opinion *Universal Battery Co.* v. *United States*, reported in 281 United States Reports, p. 580, which is the leading case on this subject.

sales, gross or net, is clearly more economic and more efficient than any excise tax which rests upon statutory definition of articles to be taxed and administrative interpretation of such definition. The existing excise tax on refrigerating and air-conditioning equipment is fundamentally uneconomic and unsound. In the interest both of the public revenues and of the welfare of the taxpayers, this tax should be repealed and a general sales tax substituted. However, the above-mentioned amendment is offered as an alternative to complete repeal.

Our industry does not seek to reduce the amount of taxes it pays. We are not seeking to avoid our fair share of the tax which must be collected if this war is to be won and if inflation is to be minimized, but we are concerned that there be the greatest economic value from whatever taxes we do pay.

Thank you very much.

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

Mr. Seghers?

STATEMENT OF PAUL D. SEGHERS, NEW YORK, N. Y., REPRESENTING THE FEDERAL TAX FORUM

The CHAIRMAN. All right, Mr. Seghers.

Mr. SEGHERS. My appearance today is on behalf of the Federal Tax Forum—a group of taxpayers, certified public accountants, lawyers, and tax executives, who meet twice a month in order to interchange ideas and information on practical tax problems.

Our number is not very large, but our members deal with returns involving millions—many millions—of income and hundreds of millions in property. We would like to have you think, however, of our appearance here not so much to represent any class of taxpayers, not to represent taxpayers as a group, but as citizens who feel that they have some special knowledge, qualified by experience to speak on the subject of raising the maximum amount of income with the least damage to production, the production of the tools for victory—things that we need to win this war.

We are here to speak of means of raising taxes as well as to speak of technical improvements in the bill, in order to improve its efficiency.

"The power to tax is the power to destroy," one of the great judges said, and this Congress, that must levy an almost crushing burden of taxes, must exercise extreme care lest that power damage not only taxpayer morale, but damage the corporations, the manufacturers that are producing the things that are needed in war.

Our recommendations are divided into three parts—the retail sales tax; an integrated plan of taxation of corporate incomes, and some general recommendations for relief and technical improvements.

Each will be briefly outlined, with the request that any questions that you may have will be made wherever you feel that they will help to clarify the recommendations that are being made.

We have a list of a large number of recommendations that have heretofore been made by the forum over the past 2 years, and little by little have been adopted by Congress to date.

We will furnish that list at this time, or as a part of the statement which we request leave to file.

First, as to the retail sales tax: The Federal Tax Forum, its members in general, are opposed to the principle of a retail sales tax. We have even expressed ourselves as being opposed to it.

Since the beginning of this year, however, we have been brought to the conviction that, as an anti-inflationary measure, as well as a source of revenue, its advantages outweigh its disadvantages.

In that change of viewpoint we have followed somewhat the course of the National Retail Dry Goods Association, which for many years was opposed to any form of retail sales tax, and which has now come out in favor of a retail sales tax, because—principally because—it feels that it is an anti-inflationary measure, and that it is more important for them to do anything to prevent inflation than it is to avoid the burden which falls on them in collecting retail sales taxes.

A retail-sales tax is politically unpalatable at this time.

It undoubtedly takes courage to brave unseen submarines and face machine-gun bullets, and it takes courage, here in Congress, to face this issue now and deal with the sales tax now instead of waiting until after the coming election.

There is little doubt that each of you knows that within 6 months we will have a sales tax.

The quetion is: Are you ready to face the fact now? Perhaps the silent masses of voters are not so unthinking as to hold you to blame for passing a measure at this time, but are more likely to blame Congress should it fail to take this essential step to check the dreaded plague of inflation, which will cause so much suffering to the very people that Congress is seeking to spare the burden of this retail-sales tax.

Let me repeat that, in our advocacy of the sales tax, we are not speaking as tax experts in that field, but speaking rather as citizens, because the question of sales tax is rather one of economics and of politics, but we do feel that we have given a great deal of thought to it, and we speak for what our recommendations may be worth.

However, as to the remainder of our recommendations, we feel that we are entitled to be heard, as men who have given their lives to the study and the practice of Federal taxation.

All of our recommendations, including that in favor of a retail-sales tax, reflect the majority view of our membership, obtained through questionnaires, two of which were sent out this year, and also have the support obtained through a questionnaire sent out to a similar Federal tax group in Philadelphia.

Our next general recommendations relate to an integrated plan of taxation of corporate incomes.

If you will permit me to read them through, I would then be very happy to go into further detail on each point.

I might say, in introduction, that such a plan could produce very much larger revenue, depending on the rates that you see fit to use, at a lower top-bracket rate than you are now using, and would relieve some inequities and some inefficiencies.

The major features of the plan are these:

First, eliminate the capital-stock tax and the related declared-value excess-profits tax.

Second, limit the aggregate normal and surtax rates on corporate incomes to 40 percent.

Third, compute the excess-profits tax on the balance of the income, after deducting the normal and surtax. That is, we advocate return to the 1940 method.

Fourth, the rate of exemption or credit under the invested capital method to be equal to the average rate earned by the taxpayer during its base period, with a maximum of, say, 15 percent, and a minimum of, say, 6 percent.

Fifth, if the income form of credit is used, it is not to exceed an amount equal to, say, 20 percent of invested capital for the taxable year, subject to the relief provided in section 213 of the House bill in the case of abnormally low invested capital.

Now, those are the high points of our plan, and you will not find anything radical among them.

Senator BYRD. May I ask a question?

Mr. SEGHERS. Yes, sir.

Senator BYRD. Have you made an estimate of the revenue?

Mr. SEGHERS. The revenue will hinge on the excess-profits rate that you use.

Such a plan, with the 90-percent rate, of course, would be absolutely crushing.

An 80-percent top rate would raise much more revenue than you will get under the House bill. Seventy percent would probably raise more.

You will note that this tax does not propose to leave in the hands of those enjoying a monopoly privilege due to good earnings in the 4 years of the base period—it doesn't propose to leave in the hands of such taxpayers 55 percent of their income, as the House bill now proposes.

The 90 percent sounds very big, but the corporation that had a favorable base period earning is delighted with that plan.

They say, "Tax us a hundred percent; we are very happy, because the portion that you put into the normal tax bracket, which escapes the excess-profits tax, leaves us 55 percent of our income."

You are putting a lower burden, then, on the taxpayers best able to pay a tax.

Now, there may be economic arguments in peacetime against taxing those who are best able to pay the tax. You may say that the more efficient producer should be rewarded by a low tax and not punished by a high tax, but in wartime, when you take men's bodies and lives, not because you are punishing them but because you feel it is their duty and their privilege to serve, there is no reason why income shouldn't be taken from those best able to pay, and I submit that a corporation which has had and continues to enjoy very fine prosperity for 6 years is better able to pay a tax than one which can earn only a small income on its invested capital, and had a small income during the first 4 years of the present 6-year period.

What brought that statement out was your question whether I had made an estimate.

As I say, that estimate could be figured on the basis of what will be your top bracket.

A 90-percent top bracket, I don't care how small it is, if it only hits 10 percent of the net income of a corporation, is an incentive to extravagance; if a corporation knows that expenses represent only a

loss of 10 cents out of every dollar, they will be less careful in keeping expenses down than if they are allowed to retain 25 cents out of the top dollar of their income.

Now, I am not speaking of the over-all rate. The net rate may be 30 percent for that corporation, but if its top bracket is 90 percent it is an encouragement to extravagance. If you raise the same amount of tax from the same corporation, and the top bracket is 75 percent, the same number of dollars of tax on the income, the same average rate, but your top bracket is 75 percent, there will be more incentive to economy and efficient operation, and that is the reason that we recommend that the basis for the computation of the excess profits be the excess profits—that is, the profits left over after the payment of all expenses including the normal tax, and over and above whatever credit is determined to be fair, and not a dividing of the income into two halves, the sheep and the goats, and those who are fortunate enough to fall on the sheep side retain 55 percent of their income.

I am not against allowing any corporation to retain 55 percent of its income, but I say, if you have a war to win, and you must impose an absolutely crushing burden on some corporations, if you must impose a very high tax in relation to the investment on some corporations, that it is not fair that other corporations that have that monopoly advantage of a 4-year high income be permitted to escape with a very much lower tax, and allowed to earn an unlimited amount of income, subject only to the normal tax and surtax, unlimited with respect to the amount of their investment.

Now, I think I have finished the last point on that. I might mention, in regard to the elimination of the capital stock and the related declared value excess-profits tax—that would mean very little loss of revenue to the Treasury if your top bracket is 90, or even 80 percent.

Under the present House bill only 10 percent of the income collected under those two taxes would be retained by the Treasury, since it would come out of the top bracket, the 90-percent bracket, and the Treasury would lose in excess-profits tax what it gained in capital-stock stock, except to the extent of 10 percent.

To go on to the third group of our recommendations: We have not yet studied carefully every word in the present House bill, which is very voluminous.

Our work is heavy, despite the season, and has not permitted it.

We have only a few general recommendations directed toward the House bill:

1. *Bad debt deductions.*—The majority favors including a provision that the year of ascertainment or charge-off of bad debts be presumed to be the year of worthlessness, in the absence of proof to the contrary.

This has to do with section 119 of the House bill. The minority of our members favors this recommendation only as to business bad debts. All are agreed that the new provision in section 119 of the bill, while affording needed relief in many cases, will lead to many practical difficulties in connection with business debts, in the absence of the provision that we are now asking: that the year of ascertainment and write-off be presumed to be the year of worthlessness, in the absence of evidence to the contrary.

As a practical matter I can assure you that the absence of that qualification will lead to endless difficulty.

2. *Fiscal year taxpayers.*—The majority of the members of the forum oppose the change from the existing method of computation of the tax liability, in the case of fiscal year taxpayers, proposed in section 129 of the House bill.

The arguments against the proposed change include:

The unfairness of retroactively imposing an unanticipated additional tax liability of this kind upon taxpayers, many of whose fiscal year reports for 1942 have already been issued. Parenthetically I might point to Mr. Hawley's statement in that regard. His fiscal year is closed and yet he is confronted with an unascertained contingent liability which cannot be known until the present bill is passed.

The burden of having to go through the complicated processes of computing the tax liability for a single taxable year, under the provisions of two radically different and extremely complicated tax laws, apportioned under an arbitrary formula based upon an assumption more often wrong than right, and the unfortunate adverse influence which it would have upon the widespread movement for the adoption by business of the natural business year, which has such great advantages for both the public and Government.

These considerations outweighed the feeling that it would be more equitable to impose the same rates of tax upon all incomes earned in the calendar year 1942, regardless of the fiscal year covered by the particular tax return.

3. *Disallowance of capital and other losses.*—The forum opposes taxing as *income* what is not in fact income. This is the result if real losses, whether capital in fact or by legislative fiat, are disallowed as deductions in arriving at net income. There is nothing fair or democratic in jumping on a man when he is down, and to tax income without allowing the deduction of losses has that effect in the majority of cases. Reasonable limitations on losses, yes; but complete disallowance, no.

4. *Section 3801 should be amended.*—Section 3801 should be amended to afford taxpayers the same relief against double disallowances of deductions which is now afforded to the Government against the allowance of double deductions. Both taxpayers and the Government are now protected against double taxation of the same income under section 3801—why not the same mutuality of fairness in the case of the disallowance of deductions?

Some relief in that direction has been included in the House bill in regard to the 7-year period of limitations in regard to bad debts and other losses, but it is not a complete relief. It does not afford complete mutuality in fairness of treatment of the double disallowance of deductions.

5. *Section 734 should be amended.*—It should be amended to correct its many admitted defects and injustices. This has been promised taxpayers, and it came as a surprise and a disappointment to discover its omission from the present bill. Others have spoken eloquently and at length before the House Ways and Means Committee on this subject. You have heard Mr. Satterlee and Mr. Blodgett speak on that, and we only add our request to theirs, that the amend-

ment contain, inter alia, specific provision permitting taxpayers to recede from an inconsistent position. The Treasury Department has given assurances that this will be permitted, but there is no protection under section 734 as it now stands.

6. *Accounting principles.*—This recommendation is moss-covered, but if we keep on trying perhaps the Treasury itself will some day come out in favor of it, as it has in favor of consolidated corporate income-tax returns and many other needed reforms this year. We recommend the inclusion of the following provision in the Internal Revenue Code, believing that it will afford a solution for many problems, in a fair and practical manner, thereby avoiding much litigation:

> Generally recognized principles of accounting in common use are to be followed in determining what is gross and net income, the year of its realization, and what constitutes paid-in capital and earned surplus, except to the extent, if any, that such determination in any instance is clearly contrary to specific provisions of the Internal Revenue Code.

We are asking common-sense business law, business practice, in the absence of congressional intent to the contrary. We do not ask that taxes be determined in any way other than Congress provides, but where Congress is not specific we ask that business practice and common sense be followed.

Recognized accounting principles should be easily determined. We do not say "best accounting principles," because that would raise a dispute between one man and another as to what is the best practice. There are practices in common use, recognized as good practices, and yet not exclusive. The law may be very specific, but even so we find that there are instances which arise, in which there is nothing specific on the particular point, and then it means a court case or endless arguments with the Bureau, whereas if we could turn to established and recognized accounting procedure it would avoid those things.

7. *Post-war refunds of a portion of excess-profits taxes.*—This subject was not covered by the forum's questionnaire, but there is sentiment in favor of such a provision, to serve as a ready-made cushion for the transition period, pending the enactment of further legislation in the light of then-existing conditions.

We don't believe that Congress can legislate today and foresee all the conditions that will exist after the war, but we do believe we should have embodied in the law provisions of some kind that would indicate an intention to afford some sort of relief, even though not perfect, which would be very helpful, during the transition period, until more adequate laws can be passed, and on that subject I might mention two other points for which there is sentiment, but which were not covered in our questionnaire or discussion.

Inventory reserves.—We realize the great complexity of that subject, but we can see advantages in a provision of that sort, or some other provision which would allow, after hostilities end, a 2 or 3 months' period for retroactive valuation of inventory, such as we had after the last war.

Such a provision may not perfectly fit conditions, but at least it will afford a promise, it will afford some confidence to business.

Retroactive net loss deductions.—Another similar provision foreseeing the post-war situation is the provision for retroactive net loss

deductions. We had that also after the last war: A provision that a net loss could not only be carried forward but, following the war, that it could be carried back 1 year.

That would give business far greater confidence, and it would offer a great cushion against a depression.

8. *Relief that relieves.*—How to enact relief provisions which will afford adequate and timely relief in the manner intended presents a problem for which we do not offer a solution. The Treasury seems determined to correct what it considers excessive generosity of Congress with respect to relief. It is devoting tireless efforts to the evolution of theories to prevent allowance of the relief that Congress apparently intended to grant. Even further—the law itself seems to contain some clever little tricks to deprive taxpayers of the relief to which they would appear to be entitled. You are constantly hearing of difficulties in administering the various types of excise taxes; it is because of the attitude of the administrative officers—each one seeks to get a little more revenue, to reach a few more transactions than his predecessors have reached—and we are having the same difficulty with relief.

The attempt is: "How can we prevent Congress' excessive generosity from taking away from us the income we expect?"

An example of the "clever little tricks" is to be found in the amendment of section 721 (a) (1) proposed in section 213 of the present bill.

The forum has not had an opportunity to discuss this at its meetings, but this amendment would appear to require the exercise of a binding option which might deprive the taxpayer of practically all the intended relief, in case of a wrong guess as to the outcome of a claim for relief under either section 721 or 722.

Furthermore, I might comment that, based on my recollection, it is contrary to what the House said it intended to put into the 1940 act in that regard.

Some members of the forum oppose what would appear to be desirable limitations on the amount of excess profits credits allowable, limitations desirable in the interests of raising war revenue, because of the fear that the relief provisions which should afford adequate protection against excessive hardship or inequity in such cases cannot be relied upon to afford proper and timely relief, due to this attitude of the Treasury.

Of course, an appeal may be had to the United States Board of Tax Appeals, but only after the payment of at least two-thirds—and in many cases more—of the tax involved in the case of relief under section 722 in the form proposed in the House bill.

Senator BROWN. What do you think of the proposal that they have the relief administered by an independent three- or five-man board, instead of by the Board of Tax Appeals?

Mr. SEGHERS. You mean instead of the Board of Tax Appeals?

Senator BROWN. Instead of the Board of Tax Appeals.

Mr. SEGHERS. I see no point in depriving taxpayers of the possibility of a review by the entire Board. The Board usually tries cases by using divisions.

I can't see what is to be gained by taking that discretion away from the Board.

It would seem that the Board should have this power rather than that a three-man or larger committee have it. Incidentally, the Board could take care of that by appointing all but one of their members as that division.

Such legalistic tricks of words and definitions are rather common, even in tax acts these days.

Senator BROWN. I understood that there was considerable sentiment for it, except that there was some hesitancy about creating another bureau.

You speak of expedition, and I think that is what is needed, with respect to section 722, because there are going to be a great many applications to it that are applicable only to one corporation, and it seems to me that the sooner that corporation can find what the rule is going to be with respect to the relief to be granted it, the better it is, and if you wait for a determination of the Board of Tax Appeals, which I understand are often delayed, it seems to me the corporation isn't going to know what rule is going to apply to it for quite a long period of time.

If you could have it decided expeditiously, so that it could know what rule is to be applied to it, it would be, it seems to me, in the interest of good taxation.

Mr. SEGHERS. Well, Senator, I agree with every word that you say.

Let me just clarify my reply to what I understood to be your question. I agree with everything that you said. I might say that we have been advocating a special board or a special power in the Board of Tax Appeals, from our earliest appearance in 1940—in August 1940.

We made that recommendation—either a special relief board or a special power within the Board or reposed in the Board.

I was seeking only to answer your narrow question, as to whether it should be limited to a division or whether the Board should have the power to review.

Now, it's my understanding, as to the time element, that the Board does not review the majority of its cases that are decided by its divisions, and that even where it reviews them, in the majority of cases it does not unnecessarily or unduly delay.

I think that, of all administrative bodies, we can count on quicker and fairer treatment from the Board of Tax Appeals than any other, and I think, whether you limit it to a division or whether you turn it over to the Board with perhaps the suggestion that it be heard and decided by a special division, and stop there—don't say that it is not reviewable by the Board; don't say that it is reviewable; leave it to the Board's discretion, the plan is excellent.

I thought that was your question, and I was seeking to answer only that narrow point, but in general I agree with your reasoning and conclusions.

The CHAIRMAN. Have you any other point?

Mr. SEGHERS. After that serious discussion I hate to mention it, but before the House there was a great deal of interest in a national lottery.

9. *A national lottery.*—The Federal Tax Forum makes no recommendation, but a number of the members individually suggest the desirability of a national lottery as a means of raising very great sums of revenue and syphoning off just the excess purchasing power

that is likely to lead to inflation and is now going in part into racing, numbers, and other forms of uncontrolled gambling.

Samson used the jawbone of an ass to wage a successful fight—could we not use the gambling instinct to help in our fight for existence?

The CHAIRMAN. All right, Mr. Seghers. Thank you very much for your appearance.

MR. SEGHERS. Thank you.

(The following list of recommendations and questionnaire were submitted by Mr. Seghers:)

Recommendations made by the Federal Tax Forum at hearings on revenue revision before congressional committees and adopted to date (Aug. 1, 1942)

[List of principal specific recommendations only]

Subject of recommendation	Hearing report			Addition or amendment	
	Year	Body	Page	Act or bill	Section
Relief board, with wide discretion but limited powers.	1940	Joint	151	1941-A	732.
	1940	Senate	24 and 28		
	1942	House	1961	1942	213 (d).
Consolidated corporate income as well as excess-profits tax returns.	1940	Joint	150		
	1940	Senate	25	1942	215.
Abnormalities in deductions, base period adjustments.	1940	do	24	1941-A	710 (b) (1) (H), (I), (J), (K).
Income attributable to other years, adjustments in taxable year.	1941	do	1230	1941-A	721.
Successor corporation of partnership or individuals, right to use income credit.	1940	do	25	1941-A	740.
New corporations, right to use income credit.	1940	do	37	1941-A	741.
"Growth" companies, increased credit under income methods.	1940	do	25	1941-A	713 (f).
"Growth corporation formula," allowance to successor corporations.	1941	do	1229	1942	210.
Invested capital or income credit, whichever results in the lower tax, allowance of.	1940	do	149		
	1940	do	24	1941-A	712 (a).
Invested capital, changes during taxable year, treatment of.	1940	do	35-36	1940	718.
Invested capital, basis of assets, method of determining.	1940	do	38	do	718.
New corporations, higher invested capital, allowance of.	1940	do	37	1941	718 (a) (6).
Treasury stock, treatment of, to be covered by regulations.	1940	do	37		Reg. sec. 30, 718-725; sec. 30, 720-721.
Carry-over of excess-profits credit, allowance of.	1940	Joint	151	1941-A	710 (c).
Extractive industries, special relief	1940	do	37		
	1940	Senate	38	1942	213 (a).
Deduction for expenses of producing taxable income, retroactive application.	1941	do	1226	do	118.
Bad debts deductions, elimination of requirement of charge off and ascertainment.	1941	do	1231	do	119.
Double disallowances of deductions, relief against. (Note: Partial relief proposed in 1942 bill.)	1940	Joint	151		
	1940	Senate	38		
	1941	do	1229		
	1942	House	1960	1942	150.
"No tax benefit," recognition of, for equitable treatment of recoveries of bad debts, etc.	1940	Senate	36	do	114.
War profits, not to be taxed at higher rates than incomes of other taxpayers.	1940	Joint	150	None	None.
Refund claims, waivers to extend period of limitation.	1941	Senate	1231	1942	150.
Withholding tax on salaries, dividends, interest.	1942	House	1958	do	153.
Amortization, relief from improper administration of provisions with respect to nonreimbursement.	1941	Senate	1228	1941 and 1942 amendments.	

FEDERAL TAX FORUM,
New York City, July 29, 1942.

CONFIDENTIAL QUESTIONNAIRE

1942 REVENUE BILL

1. Please express your views (in the manner indicated in subparagraphs (k), (l), and (m) below), on the following integrated plan for the taxation of corporate incomes (this is the same proposal as approved by the Forum in the questionnaire of March 18, 1942, and presented to the House Ways and Means Committee April 2, 1942):

(*a*) No capital-stock tax.
(*b*) No declared value excess-profits tax.
(*c*) Aggregate normal tax and surtax (on incomes over $25,000) not to exceed 35 percent; 40 percent; _____ percent.
(*d*) Excess-profits tax to be computed on balance of income, less credit (that is, under the 1940 method).
(*e*) Whatever form of credit is used, it is not to exceed an amount equal to 20 percent— _____ percent of invested capital for the taxable year.
(*f*) The rate to be used in computing the credit under the invested capital method to be not more than 15 percent— _____ percent or less than 6 percent— _____ percent, depending upon the average rate of return earned by the taxpayer on its invested capital during its base period.
(*g*) "The amount of income to be taxed in each bracket (except the top bracket) to be computed as a percentage of the total excess-profits credit, rather than by flat dollar amounts, as under 1941 act."

(NOTE.—This item included for its historical interest—little chance now of departing from proposed form of a single, very high excess-profits rate.)

(*h*) "Relief against destructively high taxes to be provided by giving a Relief Board (or B. T. A.) wide latitude as to grounds for relief, but limitations on right to appeal and extent of relief (similar to provisions of sec. 722.)"

(NOTE.—"For the record," as we now seem to have this.)

(*i*) "Relief to be afforded where value of assets needed in production (excluding intangibles) is substantially in excess of basis for inclusion in invested capital."

(NOTE.—"For the record." See sec. 213 of the bill.)

(*j*) "Higher rates will be necessary to compensate for elimination of capital-stock tax and related declared value excess-profits tax, as well as to raise greatly increased revenue. Every effort should be made to adjust burden to ability to pay, so as not to destroy productive capacity of industry."

(NOTE.—"For the record"—we have the 90 percent rate—we need the equitable adjustment to ability to pay.)

(*k*) Please indicate here if you are in favor of the general principles exemplified in the foregoing plan. Yes _____; no _____.
(*l*) If answer is "No," please indicate (by subparagraph letter) what principles, if any, you do favor _____

(*m*) Other recommendations or comments in regard to the above integrated plan:

2. Please indicate your views as to some plan for effecting the purpose of compulsory joint returns, and, if in favor, indicate any details you favor, such as (for example), exemption of first $5,000 of income of each spouse from requirement to be included in joint return (with proviso that aggregate tax of both should be not less than if two separate returns were filed):

3. Please indicate your views as to provisions in the bill (sec. 129) relating to fiscal years. Arguments against include: Retroactive effect, resulting in unexpected and unanticipated tax liability even in cases of fiscal years already ended in 1942; handicap on the campaign for the use of the "natural business

year" by all corporations. Arguments in favor are equity of taxing all 1942 income at 1942 rates, regardless of what fiscal year is adopted by a corporation or other taxpayer. (Another argument against, is that the method of allocating the liability will distort the results in many cases.) In your reply, please indicate if the Forum should oppose the new provision, or only oppose its retroactive application to fiscal years which began in 1941----------

4. Are you in favor of the Forum making the recommendation that the provision relating to bad debts (sec. 119) be amended to provide that debts shall be presumed to be worthless in the years of "ascertainment and charge-off," in the absence of proof to the contrary. If in favor, please indicate whether you favor this recommendation as to business debts or as to all debts. (The latter might in many cases work a hardship upon individual taxpayers, and partially nullify the relief intended to be afforded by the new provision)----------

5. Please indicate below any comments, criticisms, or suggestions in regard to what is included in or omitted from this questionnaire, in order that the representative of the Forum may be guided thereby----------

The CHAIRMAN. Mr. Tanzer?

STATEMENT OF LAWRENCE ARNOLD TANZER, NEW YORK, N. Y., REPRESENTING THE COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.

The CHAIRMAN. How long will you take?

Mr. TANZER. I shall be as brief as possible. I realize the difficulties of the committee, but our association has given a good deal of time and thought in an effort to indicate some general considerations.

The CHAIRMAN. Can you indicate how long it will take you to present your views?

Mr. TANZER. I think I can present them to you in 20 minutes.

The CHAIRMAN. We can't allow you 20 minutes, Mr. Tanzer. Go ahead, and try to confine yourself to 10 minutes, because we are going to have to put limitations on witnesses.

Mr. TANZER. I could stay over, if I could be heard the first thing in the morning.

The CHAIRMAN. We can hear you now. You have a written statement anyway, haven't you?

Mr. TANZER. Yes, sir.

I appear as chairman of the committee on taxation and public revenue of the Commerce and Industry Association of New York, Inc., formerly known as the Merchants' Association of New York, the largest chamber of commerce in the city of New York, to lay before you the views of that association, adopted by vote of its executive committee upon a report of our committee made after careful consideration of the provisions of the revenue bill of 1942.

The merits of the proposed legislation have been obscured by centering public discussion on the difference between the amount to be raised by the bill and the amount of additional revenue asked by Secretary of the Treasury Morgenthau. The Secretary of the Treasury has several times during the past year changed his requests and estimates. In 1941, he favored financing the war effort, two-thirds by taxation and one-third by borrowing, but this was soon found to be impossible. In testifying before the Ways and Means Committee on March 3, 1942, he asked Congress for a tax bill to raise

$8,610,000,000 additional revenue, which, after an allowance for interrelated effects, he estimated would yield $7,610,000,000 net. No reason was assigned why the amount to be raised should not be more or less than that named by him.

The Ways and Means Committee submitted to the House of Representatives a bill estimated to raise $6,139,900,000 additional revenue. By amendments adopted on the floor of the House the yield was increased $131,300,000 to $6,271,200,000.

These differences are in no sense determinative of the merits of the bill. The maximum amount requested by the Secretary of the Treasury would be utterly inadequate in relation to the requirements of the war effort if more could be raised; and the amount proposed to be raised by the bill as passed by the House is excessive if it cannot be levied without impairing the production necessary to carry on the war and the realization of future revenues needed for its continuance.

The expenditures of the Federal Government for the fiscal year 1943 were estimated as of April 24, 1942, at over $73,000,000,000. The estimated revenues under existing laws are approximately $17,000,000,000, resulting in a deficit of some $56,000,000,000. The proposed additional taxes voted by the House, estimated to yield for a full year $6,271,200,000 and for the remaining portion of the year 1943 approximately $4,257,300,000, would leave nearly $52,000,000,000 to be raised by borrowing. The gross Federal debt as of June 30, 1942, was approximately $77,000,000,000 and by the addition of $52,000,000,000 would be increased to $129,000,000,000 by June 30, 1943. Even an increase in the yield of additional taxes by $2,500,000,000 additional, up to the maximum amount asked for by the Secretary of the Treasury, would be insignificant in comparison with the needs.

Manifestly, the amount of tax to be raised for the war effort cannot be limited by any arbitrary amount. Taxation must be increased to the utmost amount that it is practicable to raise.

The only question for consideration, therefore, is how much can be raised without impairing the war effort itself and drying up the sources of future revenue. It is by this test that the proposals in the pending bill must be weighed.

Our association is strongly in favor of financing the war through taxation to the greatest possible extent. Our purpose in coming here is to make constructive suggestions for taxation that is calculated actually to raise the additional revenue required, as against taxation which would defeat that object by destroying the sources of revenue.

The association has necessarily limited its consideration to what seemed to it the most important features of the bill: In expressing its disapproval of or its concurrence with particular provisions, it does not wish to be understood as either approving or disapproving other provisions which are not here discussed.

Individual income taxes—Exemptions.—We approve of the broadening of the base of the tax by reduction of the personal exemptions to $500 for a single person and $1,200 for a married person.

Rates.—The proposed surtax rates represent such drastic increases as to raise the question whether adequate consideration has been given to the principle that increased or additional taxes ought to be levied in such a way as not to defeat their own purpose by drying up the

sources of revenue, impairing morale or working gross injustice. In considering the tax increases proposed, the Congress should consider their effect, not only on the power of taxpayers to purchase goods, but also on their power to meet obligations or fixed charges such as life insurance premiums, mortgage interest or payments on the purchase price of homes, education of the family, and the expense of sickness. The reduction of the amount available for living expenses, resulting from the imposition of the new taxes, will also curtail the amount of money available for charitable purposes and thus impair the support of all charitable and philanthropic organizations, including hospitals and educational institutions. The indirect effects of excessive taxes on the morale of the people and on the public economy, together with the effect on the taxpayers' ability to meet rents, the possible impairment of real-estate values, and more particularly the effect on future incomes out of which future taxes must be collected, should receive careful consideration.

We ask that in passing upon the rates of tax to be enacted your committee give due consideration to these factors.

Relief provisions.—We suggest also that the Senate Finance Committee consider making provision for suitable and reasonable credit in computing net income, for existing liabilities and fixed charges of taxpayers, for life insurance premiums, mortgage interest, and payments on homes, cost of illness, and other indebtedness.

Purchases of war bonds will be encouraged if a way can be found to give favorable consideration to income expended for fixed obligations of this nature.

Corporation income and excess-profits taxes.—The Secretary of the Treasury, in his testimony before the Ways and Means Committee, agreed that "a tax which dips too deeply into the incomes of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence." We believe that the rates of corporation income tax carried in the bill are so drastic as to threaten the ability of corporations generally to meet their obligations and even to continue in business, and that the ultimate effect, not only on the business of the country directly but also on the incomes of stockholders who will be deprived of their income from interest and dividends, will be to impair the production required for the winning of the war and to reduce, rather than to increase, the revenues needed to pay the cost of winning the war.

The present effective income tax rate of 31 prcent for large corporations has probably gone beyond the point of diminishing returns so as to put in jeopardy the income-tax revenues of the Government. We urge, therefore, that the rate of corporation income tax be left unchanged, or that in any event the combined rate of normal tax and surtax be not raised above 35 percent.

We urge also that the excess-profits tax be turned into a war-profits tax to expire within a limited time after the end of the war and to be so levied as to collect heavily from excess or war profits but not to cripple industry or prevent corporations from continuing to function in aid of war production or from surviving after the war or from producing earnings out of which future taxes must be collected.

In determining base period net income, we urge, as a matter of fairness, that a corporation be allowed to take the average of any 3 out of the 4 years in the base period.

Consolidated returns.—We heartily approve of the provision in the bill permitting consolidated returns for income tax as well as for excess-profits tax; but we can see no good reason for penalizing such returns by an additional 2 percent income tax, and we request that the penalty provision be omitted.

Post-war excess-profits tax credit.—The proposal of the Secretary of the Treasury for allowance of a post-war excess-profits tax credit for a portion of the excess-profits tax is, we believe, sound; but we feel that the credit should be uniform to all taxpayers and not made discriminatory by restrictions limiting its allowance to some taxpayers and not to others—the amount of each taxpayer's excess-profits tax subject to the credits should be treated as invested in war bonds, and the taxpayer should receive therefor Government obligations negotiable but not maturing nor bearing interest until after the war.

Excess-profits tax relief.—The imposition of excess-profits taxes at high rates makes it increasingly important that care should be taken in defining excess profits so that normal profits shall not be taxed at excess-profits tax rates and that there shall be appropriate relief provisions to guard against avoidable injustices.

The increase in the exemption from $5,000 to $10,000 will afford some relief to small corporations and should be retained.

The proposed reduction in the invested capital credit to 6 percent on invested capital between $10,000,000 and $200,000,000 and to 5 percent on invested capital in excess of $200,000,000 seems to us unsound and penalizing mere size, and we ask that a uniform rate of 8 percent be restored.

In computing invested capital, the bill continues, with technical modifications, the existing practice of including assets at the basis determined for income-tax purposes. This appears to be unsound as the income basis bears no fair relation to the invested capital. We request an amendment to include assets in invested capital at cost.

The bill contains numerous amendments to the excess-profits tax provisions, to correct errors and make adjustments found desirable in the working of the law. These amendments are highly technical and it seems unnecessary to discuss them in detail. Some of these amendments, however, have the commendable purpose of granting relief in cases where computation of the excess-profits tax on the basis of the fixed formulae for determining the base-period net income or the invested-capital credit would work injustice because of abnormal circumstances. They are apparently intended to grant some relief to new corporations, which would suffer an unfair disadvantage by strict application of the statutory formulae. We approve these relief provisions in principle and request that they receive further study, with a view to making sure that they fully effectuate the purpose of granting relief against inequities and hardships, more particularly in the case of new corporations not having a large invested capital.

Capital-stock tax and declared-value excess-profits tax.—Our association supports the recommendation of the Secretary of the Treasury for the repeal of these taxes. If, however, they are retained, the provision of the bill permitting annual declarations of capital-stock value would afford necessary relief from the hardships which would otherwise result from the highly speculative character of the tax. We recommend enactment of the provision for annual declaration of value, if the tax is retained.

Collection at source.—The scheme provided in the bill for collection at the source from all payments of wages, bond interest, and dividends at the rate of 5 percent during the calendar year 1943 and at the rate of 10 percent beginning January 1, 1944, should not be confused with a withholding tax. It is not a tax at all. The bill merely sets up machinery for collecting income tax in advance; all amounts withheld are credited on income taxes payable and if in excess thereof are to be refunded. With respect to bond interest and dividends, no deductions are allowed, but the withholding rate is applied to the gross amount paid, unless the recipient files a certificate that his income will not exceed his personal exemption and credit for dependents. With respect to wages, however, the withholding is only on the amount in excess of a "withholding deduction" based on each individual employee's personal status and exemptions.

Every person employed (excepting at agricultural labor or domestic service or for casual labor not in the course of the employers' trade or business), including some persons otherwise regarded in law as independent contractors, must furnish the employer with a statement as to whether he is single, married or living with wife or husband, the head of a family and his dependents. The Treasury will furnish the employer with a table showing the amount of wages exempt from withholding for each of various specified pay periods (weekly, monthly, annual, and so forth), computed on the basis of the personal exemption and dependency allowances for each different situation, plus 10 percent. The employer must then, in the case of each employee, compute the amount of his compensation, which includes all remuneration of any kind by way of wages, commissions, or otherwise, including the cash value of any housing, subsistence, or other compensation not paid in cash. He must in each case apply to the amount of compensation so ascertained the amount of withholding deduction applicable to the employee's status as shown by the employee's statement, indicated by the table furnished by the Treasury Department, or if the compensation is paid for a period other than one of the pay-roll periods specified in such table he must complete the withholding deduction himself upon the basis of the amount of the annual withholding deduction shown on the table divided by 365 and multiplied by the number of days in the period. He must then withhold 5 percent, or 10 percent, as the case may be, of the amount by which the total compensation for the period exceeds the withholding deduction. If the employee is married, the employer must also ascertain whether the employee's spouse is likewise employed, because in such case the employee is entitled to only one-half the withholding deduction.

The employer must furnish to each employee, with each payment of wages, a written statement showing the period covered, wages paid, and amount of tax withheld, and must also furnish to each employee annually, on or before February 15, or on the termination of employment, a similar statement covering the year or the period of employment. He must make return to the Treasury quarterly and pay the amount of all taxes withheld.

The employer is liable for collection and payment of all taxes required to be withheld under penalties.

All payments withheld are credited against the tax payable on the return, and any amounts in excess of the tax must be refunded. The 5 percent withheld in 1943 is to be credited against income tax for 1943

income payable in 1944, so that in 1943 each taxpayer will pay his 1942 income tax plus so much of the 1943 tax as is withheld; and the 10 percent withheld in 1944 is to be credited on the 1944 income tax payable in 1945, so that in 1944 the taxpayer will pay his 1943 income tax (less the portion withheld in 1943) plus the portion of 1944 income tax withheld at the source.

With a view to placing taxpayers who are not subject to withholding on a parity with those who are, with respect to the provisions for collection in advance, the provisions for payment of income tax in installments are amended so as to require a taxpayer electing to pay his income tax in installments to pay as the first installment 10 percent of his surtax net income, plus one-fourth of the remainder of his tax, the balance being divided equally among the remaining three installments.

The provision for the plan takes up 22 pages of the text of the bill, to be supplemented by regulations, and its explanation consumes 10 closely printed pages of the report of the Ways and Means Committee. Mr. Randolph Paul, Tax Adviser to the Treasury, has testified before this committee that this plan for collection at the source will impose a tremendous additional administrative expense, that probably 8,000 to 10,000 additional Treasury employees will be needed and that 2.5 million employers will be subject to its requirements.

From the administrative point of view, this scheme represents perhaps the most burdensome and impracticable plan that has ever been seriously proposed by any responsible public official. The burden and expense cast upon every employer in ascertaining the personal and domestic facts regarding each of his employees and keeping records and making returns, irrespective of responsibility for erroneous collections or returns, would exceed anything heretofore known, even in our present complicated tax system. In addition to the tremendous burdens proposed to be cast upon employers and other withholding agents, it is proposed to have the taxing officials of the Government assume the additional duty of determining and paying refunds in every case where the amount withheld may exceed the eventual amount of an individual's income tax.

It seems inconceivable that at a time when all the energies of Government and individuals should be concentrated on winning the war, a scheme should be seriously considered which would introduce into the tax collection machinery such burdens, complications, and uncertainties—all without contemplating the raising of a dollar of additional revenue.

We urge that the proposed plan for collection at source be eliminated from the bill.

Sales tax.—The Secretary of the Treasury's principal argument in support of the scheme for collection at the source is that it is an anti-inflationary measure. We agree with him that there is grave danger of inflation: Even after raising the additional taxes proposed in the bill, borrowings of more than $50,000,000,000 will still be required, of which it is estimated that over $35,000,000,000 must be obtained from commercial banks. The inflationary tendency of this is generally conceded.

The threat of inflation can be met only by courageous and drastic measures which will directly reach and diminish purchasing power.

That cannot be done by merely collecting a portion of the income taxes 6 months or a year in advance; it can be done in part by siphoning off some of the purchasing power by additional taxation. Income and corporation taxes have reached the point of diminishing returns; the additional revenue to finance the war effort must be obtained from other sources. Recent increases in wages have developed an increased purchasing power variously estimated at from 15 to 30 billion dollars. This increased purchasing power constitutes perhaps the largest single inflationary factor. To curb it will be in the interest of the wage earners themselves, since they will be the first and the most harmed by inflation. A sales tax will reach this purchasing power directly at the point of its exercise, will provide much needed additional revenue, and, to that extent, will diminish the need for inflationary borrowing, thus attacking inflation on two fronts.

We recommend adoption of a general retail sales tax at a rate of not more than 5 percent, nondeductible on income tax returns, and without exemptions except purchases by the Federal, State, and local governments for governmental use.

Reduction of nonessential expenditures.—The inadequacy of even the maximum amount that can be raised in taxation to finance the war and the recognized threat of inflation emphasizes the need for reducing as much as possible all nonessential governmental expenditures at this time. The latest report of the Joint Committee on Reduction of Nonessential Federal Expenditures states that while reductions have been effected up to the amount recommended by it in December 1941 greater economies can and should be effected.

We urge that the burdens of nonessential governmental expenditure be cut to the lowest possible minimum, disregarding the urgency of special interests, whether personal, local, social, political, or financial.

Capital gains and losses.—We are opposed to the provisions of the bill increasing the maximum rate of tax on capital gains and disallowing the deduction from ordinary income of long-term capital losses while taxing gains.

The attempt to justify the increase as bringing the tax on capital gains into closer harmony with increases in rates on other incomes overlooks the fundamental distinction between capital gains and ordinary income. Capital gains are not income at all in the same sense as current income; they represent the accretions of capital from which future income is earned. High rates of tax on capital gains have proved discouraging to the realization of such gains; and consequently the sound policy has been adopted of taxing them at rates low enough to encourage realizations, the income from which will yield fresh revenue. The higher the rates on income, therefore, the more important it becomes to stimulate the production of future income by low rates on capital gains.

The present proposal would reverse this sound policy. We submit that in the interest not only of greater commercial enterprise and liquidity, but also in the interest of the revenues themselves, the Congress, if it makes any change at all, should rather reduce the rate of tax on capital gains to perhaps 10 percent, the rate proposed in the Boland bill (H. R. 6358).

Any change which may be made in the tax on capital gains should not take effect until 1943. A change retroactively applicable to 1942

would be unjust to taxpayers who have been encouraged to make sales in reliance on the provisions of existing law.

Liberalization of the law in favor of taxpayers, and changes in administrative provisions.—The bill contains numerous changes, mostly proposed by the Secretary of the Treasury, intended to correct inequities and remedy oversights, only a few of which can be discussed here. Insofar as they are aimed at correcting inequities in the present law, we heartily approve of them.

Amortization of emergency facilities.—We particularly approve of the proposed amendments extending the amortization privilege to individuals and partnerships and making it applicable to facilities completed or acquired after December 31, 1939.

Fiscal-year taxpayers.—We oppose as most unjust the proposal to abandon retroactively the rule which has been in force continuously since 1934 of making amendments applicable only to fiscal years commencing during the year in which the amendment is enacted. The retroactive application to existing fiscal years of new provisions is calculated to upset business arrangements and practices and to subject to unforeseen tax liabilities past earnings which may already have been distributed as dividends.

Tax benefit rule.—We commend the proposal to enact into law the rule heretofore applied by the United States Board of Tax Appeals, that recoveries of bad debts and other deductions of prior years shall be treated as taxable income only to the extent to which the deduction reduced the taxpayer's income tax liability, and we recommend that the provision be broadened so as to apply also to deductions taken in prior years for rent, interest, possible claims, and other items which subsequently turned out not to be payable.

Alimony.—We approve the amendment making alimony payments taxable to the wife and deductible by the husband.

Nontrade or nonbusiness deductions.—We approve the proposed allowance of deductions for expenses in connection with the production and collection of income and for the management, conservation, or maintenance of property held for the production of income and for depreciation on such property, and suggest that the provision be broadened to include expenses incurred in connection with dealings of any kind in relation to such property.

Distributions in liquidation.—We commend the proposal to treat partial as well as complete distributions in liquidation as capital gains or losses.

Income from sources without the United States.—We oppose the proposed repeal of section 116 (a) of the Internal Revenue Code, which exempts from income tax the income of a nonresident citizen of the United States received for personal services rendered abroad. Domestic corporations with foreign branches would be placed at an unfair disadvantage as compared with foreign corporations if their employees residing abroad are required to pay double income taxes on their compensation—to the United States as well as to the country of their residence.

Statute of limitations.—We approve of the proposed amendments giving taxpayers the same period of time in which to file claims for refund as the Government has to assess taxes, in cases where the return is filed before the due date, and where the time for assessment is extended by waiver.

Estate tax—powers of appointment.—We oppose as entirely unjustified the proposed amendment subjecting to estate tax the estate of a person who had a general power of appointment which he failed to exercise. In such a case, nothing passes from the donee of the power upon his death, and there is no reasonable basis for taxing his estate.

Limitation of estate-tax deductions to property subject to claims.—The proposed amendment disallowing deductions for claims to the extent to which they exceed the value of property subject thereto is grossly unjust and should be eliminated. Its injustice is made clear by the illustration given in the report of the Ways and Means Committee, of an estate with $500,000 real property, $500,000 life insurance, and $600,000 of debts, which under the amendment would be allowed only to the extent of $500,000 on the ground that the $500,000 life insurance is not subject to the claims because not part of the estate. But the only theory on which the life insurance can properly be subjected to estate tax at all is that it is to be treated as constructively a part of the estate, which if it were it would be subject to the claims. Thus to treat it as part of the estate for the purpose of imposing a maximum tax while at the same time holding that it is not part of the estate for the purpose of determining the net estate, is obviously and flagrantly unjust.

In conclusion, let me say that we venture to submit these suggestions looking toward greater equity in the imposition of additional taxes because we believe that the success of the war effort calls for the raising of the maximum amount of taxation which can be effectively collected, and because we realize that the greater the need for revenue, the more need there is to see to it that the additional revenue required is raised in a manner best calculated to maintain production and morale and insure the continued production of future revenue.

The CHAIRMAN. Thank you very much, Mr. Tanzer.

Mr. TANZER. Thank you.

The CHAIRMAN. Mr. Leland Powers?

STATEMENT OF LELAND POWERS, BOSTON, MASS., REPRESENTING THE ASSOCIATED INDUSTRIES OF MASSACHUSETTS

Mr. POWERS. Mr. Chairman, members of the committee, I represent the Associated Industries of Massachusetts.

I have nothing that is in writing, and I intend to talk only in a general way, as to certain principles which I hope you will have in mind when you come to rewrite this tax bill.

I have read what took place in the way of debate over in the House.

You will find that some of the Members pray that you will amend this bill, some hope you will, and all say that they expect you will.

They evidently feel that this bill is not a particularly good tax bill—there is something the matter with it. Well, as a matter of fact there is a good deal the matter with it. One Member unwittingly expressed it perfectly—he said that the tax bill is full of dynamite.

I am sure the dynamite to which he was referring was the dynamite that will blow him up, but the real danger in this tax bill is that it will tend to destroy or limit production in this country.

When we are at war there is just one prime requisite, and that is production, and any tax bill that interferes with production is a poor tax bill, unless you can't avoid it.

The difficulty with this bill primarily is that it makes no provision and takes no account of the fact that some day some years from now this war is going to be over and we will have a period of reconstruction and rehabilitation.

There is nothing in this bill which sets up any machinery to allow the corporate form of business to put itself back into peacetime production.

If this bill goes as it is written it will definitely interfere with production during the next few years, because the rates—or certain of the rates—in the bill are excessive, and unless some safeguards are put in to permit the creation of reserves, when you come to the end of this war the Government is going to be faced with the necessity of financing the corporations.

I am not here, as I said before, to make particular, specific suggestions in a form that may be written out. You have heard certain men today who have given you some very sound either illustrations or figures—notably Mr. Hawley, and Mr. Seghers—as to the operation of the bill.

If you are going to take—and as you know under a tax bill, the Government collects in cash—practically all of the revenue of a corporation and permit it to do nothing in the way of depreciating, at an adequate rate, its buildings, or its machinery, or permit it to pay off its debts, or permit it to make inventory reserves, you are going to reduce your war production, and you may kill the goose that lays the golden eggs.

Somebody, I think, said, very fairly, a while ago, that the goose was not yet dead but he was suffering from a case of pernicious anemia.

Now, the goose is going to be a lot worse off unless you do something, under this bill, looking to the post-war rehabilitation of your peacetime economy.

While we are in a war economy anything that interferes with production is bad.

This tax bill will. It does.

There are other things that are worse—I don't need to go into those.

At the same time—and now, not when the war is over—you have got to make some provision.

How, I don't know. You may do it—if you need more revenue at the present moment—you may do it in the form of a post-war credit and nonnegotiable bonds that later can be negotiated; it may be done by the use of lower rates. But at least something must be done.

One thing more I would like to have you bear in mind, and that is that the rain falls equally on the just and the unjust. This tax bill, with the rates that are in it, is an extremely onerous bill for those who have no priorities, for those who are engaged in peacetime industries. They were thrown in by definition as if they were war industries, making excess profits, which they haven't really made at all, and the burden on them is particularly hard, and particularly so with those who haven't reserves and who have debts.

We have got to keep up our production of war materials. We have also got to keep up our production of civilian materials.

If you can frame a tax bill which will take care of the post-war situation you will have rendered a great service to this country.

We are not dealing with raising a specific amount of money to meet a budget. You are spending some $73,000,000,000, and by this bill you plan to raise about 24. In England they are raising 18 and spending 21.

It doesn't make, at the moment, a great deal of difference whether you raise 6 billion, 8 billion. 10 billion, or 15 billion: you are still miles short of any balancing of the budget.

I do, however, in behalf of the Associated Industries of Massachusetts, which as you probably know represents well over 90 percent of the industrial production of that State, want to say a word or two in favor of the sales tax.

Those who receive under $2,500 in income receive about 75 percent of all the income of the country, and it has been fairly, I think, estimated that that group has received about 90 percent of the increase that has come as the result of the war.

They are virtually untouched by taxes today. I say that they should pay taxes.

In this war, which is to preserve our freedom and to preserve our lives, their interest is exactly the same as yours and mine.

Property is going to pay, through high income taxes on corporations and on individuals, very substantial taxes, which would seem to fairly represent all that property could contribute.

Human beings ought also to contribute, and a sales tax which is some curb on inflation, while it will not raise a tremendous sum of money—perhaps two or three billion dollars—is one that I believe every citizen ought to be glad to bear and one which ought to be imposed.

Eventually—why not now?

Thank you.

The CHAIRMAN. Thank you very much.

(The following supplemental statement was submitted by Mr. Powers:)

SUPPLEMENTAL STATEMENT BY LELAND POWERS, BOSTON, MASS., IN BEHALF OF ASSOCIATED INDUSTRIES OF MASSACHUSETTS

I present this brief in behalf of the Associated Industries of Massachusetts.

I have read in the Congressional Record the entire House debate on H. R. 7378, the Revenue Act of 1942. It is an interesting record, interesting not merely for what it contains but for what is absent. The honesty, ability, and understanding of Representatives like Doughton, Treadway, and Reed is patent, but at the same time it would seem that a majority of the House have given no consideration to the effect of the proposed bill on sources of revenue nor to economic problems which will be presented after the war. They seem either more concerned with the effect of the bill on their political fortunes or with alleged unfairnesses of a petty nature, the correction of which would have no substantial effect on the total revenue to be produced. They seem to have no proper conception of the function of incorporated business or the economics of wartime, but, to paraphrase an old German proverb, "They cannot see the forest for the trees."

The Record is also remarkable in disclosing on the part of the Treasury the desire to impose a confiscatory rate of normal and surtax on corporations while, at the same time, expressing extreme hostility to a sales tax at any rate, no

matter how small. Such a position must be dictated not by economic but by political considerations.

If I can be of any service at all it is to point out the principles which, so far as possible, should be observed in a wartime revenue act. We are engaged in a war which has so far gone badly and which will probably last for a number of years. We must win this war but, at the same time, we should endeavor to preserve for the day when the war is over our system of private enterprise and set up safeguards against the expected depression incident to a conversion from a war to a peacetime economy.

The one absolute essential in wartime economy is a maximum of production, first, of war material, and then of civilian goods. Anything which interferes with production is evil and to be avoided if avoidance is humanly possible. There are two forces operating to limit our production—restrictive labor laws and unsound monetary legislation, which I shall not discuss here. A third is ill-advised taxation.

The second requisite for the prosecution of a war is the raising of maximum revenues with a minimum interference of production, not merely this year but during every year of the war. To exact maximum revenue the source must not be destroyed nor impoverished.

Provision must be made so that when the war is over industry can convert from war to peacetime production with a minimum of unemployment and with the prospect of being able to continue in business at a profit. What we conceive to be fairness in the treatment of taxpayers within a group should be achieved, if practicable, but theoretical or actual inequalities in treatment are of small moment at the present time. Similarly, meticulous accuracy in tax returns may be desirable, but the gaining of this end does not justify the subjection of taxpayers to undue legal and accounting expense nor to a vexatious waste of time.

As I see it the fundamental question presented is this: How can we frame a tax law that will not interfere with production, that will produce throughout the war maximum revenue, and which will provide adequate safeguards against serious post-war depression?

The right answer to this question cannot be reached without a thorough appreciation of business principles nor unless we understand (1) the true nature of corporations, (2) the functions of the management thereof, and (3) considerations which must govern their decisions.

(1) A corporation is simply a convenient form under which a relatively large number of individuals may conduct a business through managers. It is not a true person or entity and is such in law only for practical reasons. It is simply a conduit through which profits may be passed by the management to the owners. It is not the corporation which gains or suffers as the result of war or taxes; it is only the stockholders. There is no sound economic argument for any taxation of the income of corporations, but there has been such political expediency in levying these taxes that the dollar income received by the corporation has imposed on it the highest rate of tax, and then, in turn, the remainder is again taxed when received by the owners.

(2) It is the duty of management to operate the corporation for the stockholders at a profit and to refrain from taking undue risks or to make commitments which may result in financial embarrassment.

(3) Especially in time of war it is not the interest of corporate executives to make undue profits, but they are terribly concerned not only about losses but possible liquidation or bankruptcy. What they require in order to increase their production is confidence that their contracts will be performed according to their terms, that the price of raw materials and inventories will not be affected by monetary changes, that they can count on a relatively fixed labor cost while they are performing their contracts, that they will be in a position to repay their loans or to refinance the same on a sound basis when they come due, and that they may count on a tax burden which will not be increased during the fiscal year. Furthermore, they must look ahead and prepare for post-war transition to a peacetime economy.

H. R. 7378 combined with the fear of wage increases, uncertainty as to monetary stability, and Public Law 528 make it impossible for corporate executives to have that confidence which is required for them to expand, as they otherwise would, war production.

Specifically, the proposed tax on corporations deters the increase in production (1) by a combination of unduly high rates on combined normal, and surtax, and on so-called excess profits, (2) by changing the method of tax calculation by figuring the excess-profits tax first, thus treating it substantially as a normal

tax, (3) by changing the basis of the tax on fiscal year corporations, and (4) by failure to provide in any form absolutely essential safeguards against post-war conversion to peacetime production.

It is generally agreed that large profits arising from war work should be recaptured by taxes, but so far as I can discover no serious attempt has been made in drafting the tax bill to reach these profits by taxation of excess profits and to exclude from the highest rates of tax the earnings of corporations engaged in the production of civil goods which are earning no more than in pre-war years.

Generally speaking, it is the big corporations that are doing the war work, and the small ones the civilian business. The lower normal and surtax rates provided for small corporations mean nothing when balanced against a high excess-profit rate calculated on their entire income without a single alleviating provision as to inventory loss, debt payment, or post-war depression. The House bill, if not amended, will simply crucify this large group of corporations whose existence now and after the war is vital to our national welfare. In peacetime they are the economic bread and butter of the Nation, and they must be preserved. Some of our largest corporations with huge surpluses accumulated in prior years may be able to finance war expenditures without substantial borrowing, but the small corporation in many cases is today faced with extinction under the House bill through inability to pay its debts or create reserves and faces the prospect of post-war death. If something isn't done now to provide for the post-war situation, the Government will have to attempt to finance practically all business when the war is over, and for all intents and purposes private enterprise will be as dead as the "dodo."

In discussing what should be done to meet post-war conditions we should not forget that no matter how much revenue we raise by taxation it is going to be only a small fraction of our expenditures. When you are spending $73,000,000,000 and proposing to collect about one-third of that sum, it does not make much difference whether you get $2,000,000,000 more or less, but the extraction of that added revenue at this time from one group of taxpayers—namely, the corporations—may result in substantial loss in revenues in future war years and the necessity of Government credit to private enterprise when the war is over.

I am talking general principles rather than making technical specific recommendations. I don't know what may prove the best measures for post-war security. At least the enactment of the House bill offers no hope to any business. I suspect that provision should be made either for inventory reserves or for the taking of inventory losses over a number of years. Some provision must be made permitting the repayment of debt, both for what I may call the civilian corporations and also for debts contracted by the producers of war material for the purchase of inventory and the building of new plant for which there may be no use after the war. If for the sake of revenue there is a feeling that the excess-profits rates should be very high, then a substantial post-war credit in the form of bonds, nonnegotiable until the war is over, seems a happy suggestion. I understand it is demonstrable that if the combined normal and surtax rate were lowered to 40 percent with these taxes calculated first and an excess-profits tax of 80 percent applied to the balance, as much or more revenue would be raised under the act than under the House bill.

A withholding tax, such as is proposed in the bill, may be desirable in theory but as drafted is not only totally impracticable but will subject all employers to enormous additional expense out of all proportion to the amount involved or to the tax benefit that the Government may receive during one calendar year rather than during the following calendar year. If substantial additional revenue is wanted now, everyone knows that it can be secured through a general retail sales tax, and that the only reason that this has not been imposed is because of political fears and timidity. Personally, I think these fears are entirely ill founded. I believe that every wage earner in this country is willing to pay something in direct tax for the preservation of life and freedom. Over three-fourths of our total national income goes to wage earners receiving less than $2,500 per year, and of the increase in dollar income since 1940, 90 percent goes to this group, primarily to those engaged in war production. Today they are relatively untouched by direct taxes. If the protection of business and property is worth some $18,000,000,000 a year to the owners, it would seem that the preservation of life and liberty is certainly worth $2,000,000,000 or $3,000,000,000. The sales tax raises money now, is easy to collect, is paid out of cash when you have it, and if not cluttered up with requirements as to complicated returns, will not prove unduly vexatious to anyone.

The foregoing are the recommendations of the Associated Industries of Massachusetts as to principles which you should apply in dealing with the revenue bill of 1942, including, incidentally, criticism of those features of the House bill which seem to us to be the principal deterrent to attaining maximum production, to the stabilization of tax revenues, and to the creation of proper post war economic safeguards.

Respectfully submitted.

ASSOCIATED INDUSTRIES OF MASSACHUSETTS,
By LELAND POWERS.

The CHAIRMAN. Mrs. Gilman?

STATEMENT OF MRS. S. H. GILMAN, IRVINGTON, N. J., REPRESENTING THE NEW JERSEY CONSUMERS COUNCIL

Mrs. GILMAN. This statement will be rather brief.

Gentlemen, I wish to thank you, in the name of my organization, the New Jersey Consumers Council, for this opportunity to present our views upon this most important tax measure. The council, which here speaks for 150,000 people, is composed of many groups, women's organizations, consumer and cooperative groups, church people, fraternal groups, and trade unions in northern and central New Jersey. We fall, like the majority of Americans. in the lower income brackets. We feel, like the majority of Americans, that this is our war. We expect sacrifices and we are making them. Our sons, our brothers, and some of our husbands are in the armed forces. We are at work producing the weapons of this war; and we are at work teaching ourselves and our neighbors to save what we have, salvaging rubber and metal, learning and teaching better nutrition, acting as blood donors, canteen workers, Red Cross workers, air raid wardens; in short, in our communities, we are doing the tasks which must be done.

And gentlemen of the Senate Finance Committee, while we are not tax experts, we have for months been discussing this tax bill, because we know that this bill concerns us. The Secretary of the Treasury has set a revenue goal for this tax measure, and the House bill falls short of this goal by approximately two and one-half billion dollars. It has been clear to us from the beginning that the bill would fall short of the required goal, and we have been aware, also, from the beginning of the discussions in Congress, that certain influential newspapers and business groups have sponsored as a panacea for all revenue shortages the imposition of a Federal sales tax. We, in New Jersey, had our experience with a sales tax, in another, lesser emergency, and after we decided that the tax bore most heavily precisely on those people for whose relief it was supposed to provide, we rejected it. In this greater war emergency, a Federal sales tax would have an even more pernicious effect.

Let me cite for you a few figures taken in large part from our own Government sources. A family of two adults with an income of $1,800 a year would pay, under current House proposals, $80.40 in Federal income taxes for 1942. In addition, other Federal, State, and municipal taxes would absorb more than 18 percent of that family's income. That means out of $36 a week this family would pay $8 weekly in taxes. The figure 18 percent is based on 1939 figures for total taxes paid by such a family exclusive of income tax. It has undoubtedly increased but we will let it stand.

Taking into consideration a 17-percent rise, according to conservative estimate, in living costs since the European war began, the annual purchasing power of this familly would be reduced from $1,800 to $1,150. In other words, about 36 percent of its income would be absorbed by taxes and increased living costs. That is, besides the proposed sales tax, of course. Every additional penny taken from this family and even a part of the existing taxes would be taken from the sum required for this family's purchase of the necessities of life. Or do you think, gentlemen, on a $1,150 a year income this family would be able to live in luxury?

But I now wish to call to your attention another interesting fact. Two-thirds of the families in the United States earn, not $1,800, but less than $1,500 a year.

I want to insert here that I must challenge the statement of the gentleman who spoke last who said that people who receive less than $2,500 a year receive 75 percent of the income in the United States. That is totally incorrect. According to the latest figures, people who earn less than $500 a year will receive a reduction in income of approximately $400,000,000 for the year 1942. Figures show that increases in income are accruing only to those who already earn more than $2,500 a year. And it is these $1,500-a-year families, whom our newspaper friends are so fearful of leaving out in the cold, untaxed, that they advocate with daily but dignified insistence the passage of a Federal sales tax. But are these families untaxed? They paid out, according to 1939 figures, 17.3 percent of their income in taxes if they earned $1,500 a year; if they earned less than $500 a year, and there are such American families, they paid 21.9 percent of their income in taxes.

It has been stated by those in favor of a sales tax that such a revenue measure would help check inflation. But would it? On the contrary, a sales tax would automatically increase the cost of living. There has been much loose talk of siphoning off excess purchasing power. We ask, whose purchasing power? That of the two-thirds of our American families who live on less than $1,500 a year and who are special targets for the sales-tax champion anti-inflationists, and who must confine all of their buying to the purchase of necessities? The setting of price ceilings on cost-of-living items by O. P. A. must and will check inflationary tendencies in this sphere. And as for the talk of consumers bidding against each other for a limited amount of these necessities, there has thus far been no evidence of a shortage of the essentials of life in this country. However, should such a time come, should we reach the point where the necessities of life become scarce, the answer to the problem will not be a sales tax. The answer will be democratic rationing of those necessities. Otherwise, we would be using a tax to prevent the majority of the people from buying enough to eat, while a minority who still had enough money left after payment of taxes, could buy as much as it wanted of vital food, clothing, and shelter. Can you imagine what effect such a situation would have upon the morale of this Nation? Such occurrences took place during periods of extreme inflation in certain European countries, with, as we all know, very tragic results. In short, our basic objection to a Federal sales tax is that it would be a tax on necessities for the majority of the American people; that

the greatest part of this tax burden would be exacted from those least able to pay it; that it would, therefore, endanger the health and the morale of the Nation, and consequently its productive ability.

Let us now contrast the sacrifice which the passage of a Federal sales tax would impose upon the American people, a sacrifice of vital food, clothing, and shelter, with the sacrifice entailed by passage of several other tax proposals which have thus far been rejected by Members of Congress—the mandatory joint return, for instance, which the Secretary of the Treasury has advocated. It is well known that couples with large incomes often file separate returns in order to lower their tax bills, and this evasion is particularly flagrant in the community-property States.

Senator CONNALLY. Why is it any worse there than anywhere else? Most of them are poor States.

Mrs. GILMAN. In California where, I believe, the violations are particularly flagrant, the property of both people can be separated into two parts.

Senator CONNALLY. Do you live in California?

Mrs. GILMAN. I do not; but it is on record that it is so.

Has it ever been suggested that these couples would undergo cruel privation if they had to file a joint return? No. I have read something about violation of women's rights; yet I know many women who do not think the joint return is any violation of their hypothetical rights. We are at an admitted crisis in our national existence. I ask you, gentlemen of the Senate Finance Committee, to contrast the sacrifice between taking food from a family earning less than $1,500 a year and the mandatory filing of a joint return by married couples.

There are other items—among them, the taxation of State and municipal bonds and the limiting of income to $25,000 a year—which have been disregarded, but whose validity has never really been challenged. I have read, in a large metropolitan daily, an editorial admitting that the exemption from taxation of State and municipal bonds is theoretically unjust. But the admission of the correctness of a tax principle does not prevent this same newspaper from opposing such taxation in practice. The fact that some people have been investing large sums in these bonds to avoid taxation in a grave national emergency does not prevent this newspaper from congratulating Members of Congress for maintaining this exemption. There are still other revenue sources which remain untapped. Oil and mining interests are permitted to deduct from their incomes each year 27.5 percent of their gross receipts as depletion of resources credits. In some cases, as the Secretary of the Treasury pointed out, these depletion credits have more than equaled the original cost of the property, when three-quarters of the natural resources still remained to be exploited. Can the American people calmly accept a Federal sales tax while the privilege of avoiding just taxation is granted to owners of mines and oil wells?

The whole problem of the taxation of excess profits has been beclouded by talk of danger to business incentive and efficiency. Is it possible that Government and business leaders regard the retention of excessive profits as more important than the maintenance of health and decency in this Nation?

We believe, in order to achieve the revenue goal asked by the Secretary of the Treasury, that all excess profits should be taxed. There are at present certain inequities in the taxation of corporations, due to the basis upon which excess profits are computed. These inequities should be corrected. We can see no logic in the system of rebates offered to corporations. Are not normal profits sufficient in wartime? Or do spokesmen for business wish to imply that the people they represent are so self seeking that they will lose all ardor for the proper prosecution of the war unless they are permitted to retain excessive profits? We have no such low opinion of business.

As for rebates, we should like to ask if there has been any discussion of tax rebates to consumers and working people whose tax exemptions have now been reduced to $500 a year for single persons and $1,200 a year for married couples. Is there any guarantee being made to these people that their incomes will not be drastically curtailed after the war due to a fall in employment and wages? Increased taxation of gifts and inheritances would provide another source of greater tax revenue. It is shocking to the American people to learn that Members of Congress propose to raise inheritance exemptions and at the same time contemplate passage of a Federal sales tax.

We appeal to you, gentlemen of the Senate Finance Committee, to regard seriously these sentiments of low-income consumers and working people, because they are the views of a majority of Americans. We appeal to you not to take the path of least resistance, which is the most dangerous path, and reject completely proposals for passage of a Federal sales tax.

I have a few notes made following the hearing on the exemption from taxation of municipal bonds, which I would like to read.

A man who testified previously before this committee stated that he was producing war materials merely because he was patriotic; otherwise he would invest his money in municipal bonds and spend his time catfishing in Louisiana. Apparently he had something there.

I don't doubt that a number of people are following his inclination.

As has been pointed out previously, banks profit by nontaxable securities.

Everyone seems to emphasize the possible increased cost to municipal governments resulting from taxation of municipal bonds, but the fact remains that these bonds provide an outlet for funds income from which is tax-free, and at this time, in this emergency, when we have lowered income-tax exemptions to $500 for single persons and $1,200 for married couples, the maintenance of this exemption is unjust.

No bonds should be so privileged. Let all bonds compete on the investment market with their advantages plainly apparent to prospective buyers.

Let the law of supply and demand operate freely.

The fact remains that tax-free income of any kind places a double tax burden on other sources of revenue, and I am afraid that this extra burden will be loaded on to the little fellow at the end of the line.

This reminds me of Charlie Chaplin's picture The Great Dictator: Charlie is a private in the Germany Army during the last war. The general gives an order: "Investigate that projectile which has just fallen."

The officer next to the general repeats the order: "Investigate the projectile which has just fallen."

The next officer orders the officer next to him: "Investigate the projectile which has just fallen."

This officer repeats the order: "Investigate the projectile which has just fallen."

At the end of the line stands the little fellow Charlie, and he is left holding the bag. He hasn't got anyone to pass the order on to.

Senator TAFT. You gave a lot of figures on family income. What is the source of those?

Mrs. GILMAN. The Temporary National Economic Committee reports entitled, "Who Pays the Taxes?", and other reports published by the Office of Price Administration.

Senator TAFT. The 1942 figures you gave came from the Office of Price Administration?

Mrs. GILMAN. Yes, sir.

The CHAIRMAN. Thank you very much.

Mr. Haggerty, we will hear you as we have the time. It is getting a little late.

STATEMENT OF JOHN B. HAGGERTY, WASHINGTON, D. C., REPRESENTING THE INTERNATIONAL ALLIED PRINTING TRADES ASSOCIATION

Mr. HAGGERTY. My name is John B. Haggerty, chairman of the International Allied Printing Trades Association.

Mr. Chairman, I realize there has been a great deal of time consumed, and if it is agreeable to the committee, may I also submit my prepared statement for the record?

The CHAIRMAN. That is quite all right. Are you advocating a tax on billboards?

Mr. HAGGERTY. No, sir. We are misquoted there. We are advocating a levy of an excise or franchise tax on the net time sales of radio networks and commercial broadcast stations which tax will add much needed millions of dollars to the tax receipts.

The CHAIRMAN. We had a headache about billboards once before.

Mr. HAGGERTY. I am not interested in that.

The CHAIRMAN. We will try not to get into that again.

Mr. HAGGERTY. Mr. Chairman and members of the Finance Committee. On behalf of 200,000 organized skilled tradesmen, members of the International Typographical Union, the International Printing Pressmen and Assistants' Union, the International Photoegravers' Union, the International Stereotypers and Electrotypers Union, and the International Brotherhood of Bookbinders, we advocate the levying of an excise or franchise tax on the net time sales of radio networks and commercial broadcast stations which tax will add much needed millions of dollars to the tax receipts.

The need for increased taxes is so great that your committee, we understand, as well as the House of Representatives have voted to levy substantial and burdensome taxes on the incomes of workers who try to maintain a wife and a home on a meager income of even

less than $30 per week, and, on single workers with weekly incomes of even less than $15 per week.

There has been no protest on the part of the workers against the levying of these taxes they are called upon to pay despite the evident sacrifices the payment of these taxes will entail on the part of those least able to pay.

THOSE WITH PROVEN ABILITY TO PAY TO BE EXEMPT?

We do protest, however, the imposition of such taxes if those with proven ability to pay, and, especially those who obtain unusual and enormous yearly net profits through governmental grants are to be privileged to escape paying their fair share of the tax burden.

Under date of May 27, 1942, I received a letter from the Honorable Randolph E. Paul, Assistant to the Secretary of the Treasury, stating—

> The special tax to which you refer ($12,500,000 excise tax on radio networks and commercial broadcast stations) was incorporated in the 1941 revenue bill by the Committee on Ways and Means on its own initiative. It was subsequently eliminated by the Senate Finance Committee, which requested the Treasury to make a careful study of this tax. The Treasury has been studying the proposed special tax as was indicated in the Secretary's letter to you of March 5, 1942, but has not yet concluded its investigation.

We understand that in accordance with the request of your committee a plan of taxation has been proposed which was prepared by the Treasury Department and the Federal Communications Commission.

LAST YEAR TREASURY SUGGESTED TAX OF $10,000,000—THIS YEAR $1,500,000—WHY?

We are familiar with the plan proposed and we do not understand why, this year, when the need for increased taxes is greater than ever, the Treasury Department would propose a tax which, in addition to other taxes on radio networks and broadcast stations, they estimate will yield a total of some $8,000,000, when, last year, the Treasury proposed excise taxes which, in themselves, would raise in excess of $10,000,000 in additional taxes.

At this point, I might direct attention to your committee to the fact that last year the Treasury presented a 12-page brief supporting its proposal to raise in excess of $10,000,000 in additional taxes.

We presented a copy of this brief, as part of our statement, before the Ways and Means Committee and it was printed in the unrevised reports of the hearings.

However, without any notice to us, at the request of the Treasury Department, this copy of the Treasury's 12-page brief was deleted in the revised hearings on the unsupported allegation that the contents of the brief were confidential. (See hearings on Revenue Revision of 1942, vol. 3, p. 2853.)

We want your committee to know that all of the figures and other information contained in the brief are of a composite type and that there is nothing confidential therein except that it is a proposal of the Treasury Department that such excise taxes be levied.

TREASURY FIGURES CHALLENGED

With reference to the proposed plan of taxation before your committee, we note the following:

Based upon forecasts for 1942, the estimated yield at the tax rates tentatively agreed to by the Ways and Means Committee of the tax on the net time sales applied to the remaining radio stations and networks is approximately eight millions of dollars gross and a net yield of $1,500,000 since approximately $6,500,000 would have been collected in the form of excess-profits taxes, and other corporation income taxes even though these special taxes on broadcasting were not imposed.

We assume that the meaning of this language is that the Treasury this year, based upon the rate of corporation taxes tentatively agreed upon, at that time, by the Ways and Means Committee, found that the corporation taxes to be paid by the radio broadcasting industry would amount to $6,500,000 for the entire year.

It is possible, as we have been told by some members of the Ways and Means Committee, that the levying of excise taxes on the radio-broadcasting industry, as recommended by the Treasury, of some $1,500,000 was too small to be bothered with.

BOASTS OF NET PROFITS OF 680 PERCENT

It is our understanding that taxes in view of the unsual demands of the war expenditures on radio networks and broadcasting stations and everyone else this year are to be increased. If that is true, then we challenge the accuracy of the figures presented by the Treasury Department and the Federal Communications Commission. Taxes paid by corporations are no secret. They are made public to stockholders of these companies yearly. In fact, the Columbia Broadcasting System advertised in one of the trade publications, printing its first quarterly statement for 1942 as compared with the statement for the first quarter of 1941. In this ad, this company boldly publicized the fact that after paying the proposed 40 percent normal tax and other taxes and the proposed 94 percent excess-profits tax, this company would still have yearly net profits of 680 percent on their invested capital, other than on the stock issued as stock dividends.

We suggest to your committee that you definitely ascertain the accuracy of the figures presented. We know that you will find that the National Broadcasting Co., the Columbia Broadcasting System, and the radio stations WOR and WHN alone, which radio stations and networks secure less than 50 percent of the net yearly income of the radio-broadcasting industry, paid into the Treasury last year some $7,800,000 in taxes, or some 20 percent more than reportedly is to be paid by the whole radio-broadcasting industry this year in corporation taxes voted by the House of Representatives, if the figures of the Treasury are correct.

TREASURY REPORTS RADIO PROPERLY SUBJECT TO SPECIAL TAXATION

These companies, after the payment of all taxes last year, were able to pay dividends in the case of the National Broadcasting Co. of some four and a half millions of dollars; in the case of the Columbia

Broadcasting System of some three and a half millions of dollars; in the case of radio station WOR, we understand, that this station had a net income of more than half a million dollars, and, in the case of station WHN we understand that this station had a net income of more than $600,000.

We have cited these figures simply as illustrative of the fact that the radio broadcasting industry has the ability to pay, as the Treasury Department in its brief of last year, and, in its presentation this year states:

> The desirability of a special tax on radio broadcasting (distinct from a tax on advertising) one medium of which is radio—is indicated by several considerations. The principal operators in commercial broadcasting earn high rates of return on relatively small investments. They possess unusual taxpaying ability which, in view of the Government's present revenue requirements, can properly be subjected to special taxation.

Incidentally, the language which I have just read would indicate that the Ways and Means Committee in levying the excise tax on radio networks and broadcast stations last year had a strong recommendation from the Treasury Department to go on.

It is our understanding that radio station WHN with a capital and paid-in surplus of $11,000 had a net income for the last 2 years, 1940 and 1941, after ample allowance for depreciation and the payment of all taxes, in excess of $400,000; that the Columbia Broadcasting System, with a capital, other than that represented by stock dividends, of less than $500,000, had a net income, after allowing some $1,400,000 for depreciation, and after the payment of all taxes, of some $10,000,000; that radio station WOR, with a capital of $275,000, and property used for broadcasting purposes valued at some $250,000, after ample allowance for depreciation, and the payment of all taxes, had a net income for the same period of more than $1,000,000.

Surely, with such unusual net yearly profits those who secure these enormous profits should be called upon to pay their proper share of our winning of the war. Especially, is this true when you realize that these unusual and enormous yearly net profits are secured through their holding of a Government license or franchise for which the Government receives nothing.

AMERICAN FEDERATION OF LABOR COUNCIL MISLED

Considerable stress has been laid on the action of the executive council of the A. F of L., in opposing this tax and their assertion that such a tax was punitive. We want your committee to know that this action on the part of the executive council was taken without our being privileged to present facts and figures which they should have had before them, and, had they possessed this information, we are confident that they would have acted differently.

Speaking of punitive and discriminatory taxes, surely the millions of tradesmen and small businessmen and women of our country, called upon to pay—and to pay—and to make unusual and real sacrifices in order to pay the taxes which the Congress has indicated will be levied, will not call taxes which will leave the privileged few radio networks and commercial radio stations with yearly net profits, as in

the case of the network of some 700 percent, and, others with well over 100 percent, on their investments, after the payment of all taxes, either punitive or discriminatory.

STATIONS FORCED TO PAY 80-PERCENT COMMISSIONS AND DISCOUNTS TO SECURE ADVERTISING

Stress is always laid upon the alleged injury, which the levying of such taxes would inflict on the small radio-station owners. It will interest your committee to know that the radio stations located in cities of less than 30,000 population receive some 18½ percent; those stations located in cities of less than 75,000 population secure 30 percent, and those stations located in the larger cities secure only 37 percent of the advertising dollar which is paid to broadcast over these stations.

Surely, there is plenty of room from which to collect excise or franchise taxes from those who pay such unusual commissions, discounts, and rebates in order to secure advertising from the advertising agencies and radio networks.

The radio networks and commercial broadcast stations reported to the Federal Communications Commission that as of December 30, 1940, their property had a present worth value of $40,055,112.

TWENTY PERCENT NET AFTER TAXES SUGGESTED REASONABLE PROFIT

The brief presented by the Treasury last year reported a net income, prior to the levying of the proposed excise taxes, of $33,296,708. We suggest that your committee can and very properly should double the taxes voted by the House of Representatives last year on the recommendations of the Treasury Department, and, levy an excise or franchise tax of not less than $25,000,000 yearly on the net time sales of the highly profitable radio networks and commercial broadcast stations.

After the payment of these taxes, some $25,000,000, according to the findings of the Treasury, as shown in table 3, the radio broadcasting industry would still have a net income of $8,296,608, or more than 20 percent of their alleged investments.

We suggest that those few radio stations which are operated by educational, farm, religious, or labor organizations, on a nonprofit basis, be exempt from such exercise or franchise taxes, it being our belief that the Treasury Department has found that these radio stations, really serve public and community interests and are not motivated by the small profits, if any, which they receive.

In view of the fact that some members of your committee are apparently not conversant with the recommendations of the Treasury Department of last year, we ask the privilege of inserting such proposal as a part of our remarks.

Thank you.

The CHAIRMAN. Thank you very much.

There will be entered in the record a brief accompanied by a letter from Mr. Randolph Paul, General Counsel of the Treasury, the brief being submitted for the record by Mr. John B. Haggerty. The particular document which he wishes to have of record was referred to

as a statement issued by the Treasury, and the accompanying letter from Mr. Paul makes clear the character of the memorandum.

(The letter and brief referred to are as follows:)

TREASURY DEPARTMENT,
Washington, August 13, 1942.

HON. WALTER F. GEORGE,
United States Senate, Washington, D. C.

MY DEAR SENATOR: Reference is made to the request of Mr. John B. Haggerty, International Allied Printing Trades Association, that a Treasury memorandum on the taxation of radio broadcasting be included with his testimony before your committee. The memorandum referred to is an exploratory staff memorandum, prepared at the research level for interoffice use on July 18, 1941, and does not reflect Treasury policy. When the 1941 Revenue Act was under consideration, one or two members of the Committee on Ways and Means requested information on the taxation of radio broadcasting and a copy of this staff memorandum was placed at their disposal. The document was not submitted to the Committee on Ways and Means by the Treasury.

The memorandum is based in part on confidential data supplied by the Federal Communications Commission. We are advised that the Federal Communications Commission is agreeable to the release of these data at this time, and in view of that fact, no objection is entered to the inclusion of the Treasury memorandum with Mr. Haggerty's testimony.

It should be made clear that the memorandum does not contain Treasury recommendations and that the plan for the taxation of radio broadcasting contained therein differs substantially from the plan prepared this year jointly by the staffs of the Federal Communications Commission and the Treasury Department.

You will recall that when the revenue bill of 1941 was passed by the House, it contained a tax on the gross receipts of radio broadcasting stations and networks and that this tax was eliminated by the Senate Finance Committee and was not in the bill as passed. The Senate Finance Committee, at the time it was considering the matter in 1941, requested the Treasury to explore the possibilities of such a tax. In accordance with that request a plan for the taxation of radio broadcasting was prepared jointly by the staffs of the Treasury Department and the Federal Communications Commission. This plan was submitted to the Committee on Ways and Means without recommendation as to its adoption.

A statement of the plan prepared jointly by the Federal Communications Commission and the Treasury Department is herewith submitted without recommendation as to its adoption.

Sincerely yours,

RANDOLPH E. PAUL,
General Counsel.

Enclosure.

A PLAN FOR THE TAXATION OF RADIO BROADCASTING

The revenue bill of 1941, when it passed the House, contained a tax on the gross receipts of radio broadcasting stations and networks. This tax was eliminated by the Senate Finance Committee and was not in the act as passed. The Senate Finance Committee, at the time it was considering the matter, requested the Treasury to explore the possibilities of such a tax. In accordance with that request the following plan for the taxation of radio broadcasting was prepared jointly by the staffs of the Treasury Department and the Federal Communications Commission.

(A) Radio broadcasting stations, both independent and network-owned, would be subjected to the higher of two levies: (*a*) A graduated tax based upon the transmission power of the radio station, or (*b*) a graduated tax based upon net time sales. The first of these is a nominal tax in the nature of a registration fee.

(B) The network operations of networks would be subjected to a tax on net time sales.

1. *Radio broadcasting stations.*—Independent and network-owned broadcasting stations would compute their tax liability under each of two methods and pay the higher amount.

(a) *Tax based on transmission power.*—In the case of radio stations operating on unlimited time schedules, the tax on transmission power would be imposed at the following rates:

Transmission power	Tax	Transmission power	Tax
100 watts	$100	7,500 watts	$750
250 watts	250	10,000 watts	800
500 watts	250	25,000 watts	900
1,000 watts	350	50,000 watts	1,000
5,000 watts	500		

Part-time radio stations would be subject to rates equivalent to 60 percent of those applicable to stations operating without any time restrictions.

(b) *Tax based on net time sales.*—The tax based upon net time sales would be imposed on each independent and each network-owned station at rates graduated with the amount of net time sales in excess of a $100,000 exemption, as follows:

Bracket	Rate
	Percent
First $50,000 of taxable net time sales	6
Next $350,000 of taxable net time sales	8
Balance of taxable net time sales	10

"Net time sales" would be defined as gross time sales (excluding sales of talent) less commissions and outpayments to other stations and networks, plus the published card rate value of all radio time given in exchange for services, commodities, or other valuable consideration.

2. *Network operations.*—Networks, on their network operations, would be taxed on their net time sales at a flat rate of 8 percent, applied after an exemption of $100,000. The definition of "net time sales" for network operations would be the same as for broadcasting stations.

(The following memorandum was presented for the record by Mr. Haggerty:)

THE TAXATION OF RADIO BROADCASTING, PREPARED BY THE TREASURY DEPARTMENT, DIVISION OF TAX RESEARCH, JULY 18, 1941

SUMMARY

1. The case for a special tax on the broadcasting industry is supported by several considerations:

A. Broadcasters possess a profitable public franchise awarded to them free of charge.

B. The principal operators in commercial broadcasting earn high rates of return on investment and possess unusual taxpaying ability.

C. Radio broadcasting requires regulation at public expense.

2. If it is desired to impose a special tax on radio broadcasting, that purpose could be achieved by subjecting broadcasting stations and networks to an excise tax based on net time sales and imposed at classified rates. "Net time sales" would be defined as time sales, after commissions and outpayments to other stations and networks but including the published card rate value of all radio time used or given in exchange for services, commodities, and other things of value.

3. Stations with net time sales of less than $100,000 could be exempt. In 1940 this would have exempted 540 of the 765 reporting stations. This group included virtually all of the deficit stations. Its combined net income amounted to less than $730,000.[1]

[1] Operating data by size classes of net sales, and invested capital data were obtained from the Federal Communications Commission, and are unpublished and confidential.

4. To create a gross tax liability of approximately $10,000,000 the following classified progressive rates would be required:

	Percent
Broadcasting stations with time sales between $100,000 and $500,000	5
Broadcasting stations with time sales between $500,000 and $1,000,000	10
Broadcasting stations with time sales of $1,000,000 or more	15
Networks	12

5. In 1940 these rates would have resulted in a gross tax liability of approximately $10,000,000, or slightly less than one-third of net income before Federal income tax. The tax liability would have equaled 18.3 percent of net income for stations with net time sales between $100,000 and $500,000 and 42 percent for those with net time sales of over $1,000,000. For networks (excluding their station operations) the tax would have equaled 48 percent of net income.

The net burden on the industry and the net revenue to the Federal Government would have been substantially less since the imposition of the excise tax would have reduced the tax base for purposes of the net income tax and the excess-profits tax.

6. After the imposition of these rates the broadcasting industry would have been left with a very high rate of return on investment even if it absorbed all of the tax. On the average, all taxable stations would have been left with a net income equal to 43.8 percent of invested capital. The corresponding figure for networks (all network operations but excluding station operations) would have been 33.3 percent.

7. Although the industry appears to be well able to pay a tax of this type from its net income, it is probable that in the space of 2 or 3 years at least part of such a tax, if enacted, would be passed onto the advertisers and ultimately to the consumers of the advertised products.

THE TAXATION OF RADIO BROADCASTING

The case for a special tax on radio broadcasting (distinct from a tax on advertising, one medium for which is radio) is supported by several considerations.

1. Radio broadcasters are the possessors of a public franchise awarded to them free of charge, on the condition that they operate in the public interest. Because of the technical limitations of the broadcasting band, the number of commercial broadcasters at any one time is for all practical purposes limited. In consequence, a franchise to operate a broadcasting station in particular areas carries with it a measure of monopolistic privilege and the opportunity for an extremely profitable investment. Through the exercise of that privilege and the exploitation of that opportunity, many broadcasters make substantial profits and virtually all broadcasters derive less tangible benefits in the form of publicity and good will.

2. The principal operators in commercial broadcasting earn high rates of return on relatively small investments. They possess unusual taxpaying ability which, in view of Government's present revenue requirements, could properly be subjected to special taxation.

3. Radio broadcasting requires public regulation. Such regulation is provided at public expense, with great benefit to the industry but without any special costs to that industry.

THE RADIO BROADCASTING INDUSTRY

Radio broadcasting is now a $150,000,000 business and is continually growing. Total broadcast revenue increased from $108,000,000 in 1937 to $111,000,000 in 1938, $124,000,000 in 1939, and $147,000,000 in 1940 (table 1). These figures exclude a small number of nonreporting stations, with an aggregate broadcast revenue of less than $200,000.

In 1940 the industry consisted of 765 broadcast stations, 3 major networks, and 5 regional networks. The 8 networks managed and operated 31 of the 765 stations. In 1941 the number of broadcasting stations has increased substantially as a result of the Federal Communications Commission's policy of increasing the number of licensees operating in limited local areas and those operating on high frequencies.

Radio broadcasting has become an important advertising medium. Expenditures for radio advertising are estimated to have increased from $60,000,000 in

1930 to $200,000,000[2] in 1940. Today radio broadcasting is second in importance only to newspapers as a medium of advertising (table 2).

TABLE 1.—*General income statement showing the result of broadcast operations by the networks and stations, 1937–40*

	1937	1938	1939	1940
Number of stations	629	660	705	765
Time sales:				
Network portion of network time sales	$35,812,537	$35,455,510	$38,809,630	$45,494,960
Time sales by stations	80,055,694	81,923,949	91,158,396	109,620,527
Total time sales	[1] 115,868,231	117,379,459	129,968,026	154,823,787
Less commissions	16,982,960	16,487,200	17,405,414	20,859,018
Total revenue from sale of time	98,885,271	100,892,259	112,562,612	133,964,769
Sale and placing of talent	7,114,828	6,081,344	6,794,669	7,245,119
Other revenue	1,820,015	4,384,775	4,524,583	5,936,829
Total broadcast revenue	107,820,114	111,358,378	123,881,864	147,146,717
Total broadcast expenses	87,506,391	92,503,594	100,043,920	113,850,009
Broadcast income	20,313,723	18,854,784	23,837,944	33,296,708

[1] Excludes $2,040,742 duplicated in reports.

Source: Federal Communications Commission: Release No. 41487-I (Digest and analysis of evidence presented in the Hearing on Commission Order No. 27) for 1937 and 1938; Release No. 42835 (Financial and employee data respecting 3 major networks and 705 standard broadcast stations) for 1939; Release No. 50618 for 1940.

The principal source of income for commercial broadcasting stations and networks is the sale of time. In the case of the stations, sales of time amounted to $110,000,000 in 1940. Commissions to regularly established agencies, representatives, and brokers required $10,000,000, leaving a balance income from the sale of station time of $100,000,000.

The total sale of time by networks amounted to $74,000,000, $29,000,000 of which was in turn paid to other networks and stations for time purchased; $11,000,000 went into commissions. Net sale of time by networks amounted to $34,000,000. The total for stations and networks was $134,000,000.

The industry derived an additional $13,000,000 from incidental broadcasting activities, including the sale of talent. Reported broadcast expenses amounted to $114,000,000, leaving a net income before Federal income tax of $33,000,000, distributed as follows:

Networks	$8,512,060
Network managed and operated stations	5,661,089
Other stations	19,123,600
Grand total	33,296,708

A large proportion of the net income of the broadcasting industry is received by a relatively small number of operators. In 1940 the eight networks account for $8,500,000; the eight stations with time sales of $1,000,000 or more accounted for $4,600,000; 42 stations with time sales of between one-half million dollars and $1,000,000 accounted for $9,300,000. These 50 stations and eight networks received two-thirds of the net income of the broadcasting industry.

[2] Estimated radio advertising expenditures exceed the reported receipts of the radio broadcasting industry because they include an allowance for talent supplied by the advertiser or his agents.

TABLE 2.—*Estimated advertising expenditures in five media, 1928–40*

[In millions of dollars]

Year	Newspapers	Magazines	Radio	Outdoor	Farm papers	Total [1]
1928	$760	$215	$20	$85	$35	$1,115
1929	800	240	40	80	35	1,195
1930	700	210	60	65	30	1,065
1931	620	170	80	50	20	940
1932	490	120	80	35	13	740
1933	450	110	65	30	10	665
1934	500	145	90	30	14	780
1935	530	150	105	35	16	835
1936	580	170	120	45	20	935
1937	600	190	145	50	20	1,000
1938	520	145	145	50	17	875
1939	525	150	170	50	17	910
1940	545	160	200	50	15	970

[1] Totals have been rounded to nearest $5,000,000.

Source: L. D. H. Weld, McCann-Erickson, Inc., in Printer's Ink, Mar. 7, 1940, and Apr. 4, 1941.

POSSIBLE METHODS OF TAXATION

A. *Amount of power used*

George Henry Payne, of the Federal Communications Commission, proposed to tax radio broadcasting stations on the basis of the amount of power used. He suggested rates ranging from $1 a watt on stations using 1,000 watts or less to $3 a watt for stations using more than 10,000 watts.

Power utilized is an unsatisfactory basis for taxing broadcasting stations. The amount of power utilized by a station has no definite relation to the profitableness of that station or to any other measure of the value of the public franchise. Many very profitable stations operate on little power, and some of the powerful stations show little profit. The amount of power required to operate a station is determined by the density of the population in the area where the station operates in relation to the total radio audience sought. In the metropolitan areas large audiences can be reached with little power. In rural areas much power is required to send signals far enough afield to encompass even a relatively small radio audience. The amount of power utilized is determined also by geographic and atmospheric conditions. The amount necessary to send a radio signal to a given point in a mountainous area is considerably greater than that required in level country.

A tax based on power would result in an erratic tax load distribution. It would be practicable only if applied at substantially lower rates than those proposed by Mr. Payne.[3]

Moreover, a tax based on power could not be applied in the case of the networks, since the service of networks, conducted at great profit, does not require the use of electric power.

B. *Gross receipts*

A tax imposed on the basis of gross receipts of broadcasting stations and networks would create inequities without necessarily conforming to the value of the public franchise enjoyed by broadcasters. The gross proceeds of broadcasting stations include sales of talent and other services, in addition to the sale of radio time. The inclusion of the proceeds from the sale of talent in the tax base would create inequities between broadcasters who supply talent and those who supply time alone and utilize the talent provided by the advertiser. Moreover, broadcasters could readily circumvent the inclusion of talent in the tax base by altering their arrangement with advertisers.

Another deficiency of gross receipts as a tax base is that it includes receipts which are in turn distributed to other stations and networks for the purchase of time. This is principally the case with the networks.

It is debatable whether the basis of a tax designed to approximate the value of the public franchise should properly include such items as the sale of talent and other services. Strictly, the public franchise extends only to the sale of time

[3] The rate proposed by Mr. Payne would impose a tax of $150,000 on each of the 37 stations now operating with 50,000 watts.

and not to the sale of services. It could be maintained, on the other hand, that the sale of talent is a byproduct of the privilege of selling time and therefore is part of the privilege to operate a station.

C. *Net income*

Those engaged in broadcasting might be subjected to an additional income tax. Such a tax has apparent merit in that it is based on the ultimate product of the public franchise, namely, broadcasting profits. It is deficient in that inefficiently operated stations would be exempt from tax liability, despite the fact that they enjoyed a franchise which in the hands of others would be profitable. A tax based on net income would also exempt those stations which are operated less for profit than for other purposes. Publishers of newspapers and proprietors of office buildings, for instance, may derive substantial value from broadcasting in the form of publicity and goodwill, even if their operations are conducted at a loss. Moreover, broadcasting stations are frequently operated in conjunction with other businesses, with the result that the allocation of the proper share of profits to the broadcasting activities would create administrative difficulties.

D. *Net time sales*

The broadcasting industry might be taxed on the basis of net time sales: The amount of time sales by stations and networks, after commissions withheld by agents and after adjustments for outpayments to other networks and stations. Net time sales exclude the proceeds of the sale of talent and other services. It is a logical basis for a broadcasting tax because the sale of time is a direct measure of the public privilege to operate a broadcasting station.

A tax based on net time sales would create some problems with reference to radio time given without charge or traded for another service.[4] This situation would arise primarily in the case of stations owned or operated in conjunction with other business activities. It would arise, for instance, where a department store permits the operation of a broadcasting station in its building in exchange for an amount of time on the air. While some stations already report the value of such time, others do not, and many would be encouraged to discontinue the inclusion of traded time in the value of time sales. This avenue of tax avoidance could be prevented by defining the tax base as net time sales, including the published card rate value of all radio time used or given in exchange for services, commodities, or other things of value.

A large portion of the broadcasting business and broadcasting profits accrues to a relatively small number of operators. Many broadcasters earn little profits and frequently operate at a loss. Little would be gained by the imposition of a tax on this group. The 540 broadcasting stations with time sales of less than $100,000, in the aggregate, had only $24,000,000 net time sales and approximately $700,000 net income (table 3).

A comparison of 1940 net time sales with net income before Federal income tax for broadcasters in the different net time sales groups is presented in table 4. For those with net time sales below $100,000, net income represented 3 percent of time sales; for those with sales between $100,000 and $150,000, 22.1 percent. The rate increases steadily as sales increase, reaching 37.3 percent for stations in the $1,000,000 sales class.

A POSSIBLE PLAN

If it is desired to impose a special tax on radio broadcasting, that purpose could be achieved by subjecting broadcasting stations and net works to an excise tax based on net time sales and imposed at classified rates. Net time sales would be defined to include the published card rate value of all radio time used or given in exchange for services, commodities, and other things of value.

Operators with net time sales of less than $100,000 could be exempt. In 1940 this would have exempted 540 of the 765 reporting stations. These 540 stations include most of those operating at a loss. Their combined net income for 1940 amounted to less than $730,000 or 2 percent of the net income of the entire industry. The exemption of stations with relatively small time sales would also obviate the need for defining nontaxable stations. It would automatically exempt, for instance, the educational, religious, and other special purpose stations which ocasionally sell time for commercial purposes.

[4] In 1937, $345,000 worth of time was used in this manner; now estimated to be $500,000.

The excise tax might be imposed at classified progressive rates as follows:

	Percent
Broadcasting stations with time sales less than $100,000 each	0
Broadcasting stations with time sales between $100,000 and $500,000	5
Broadcasting stations with time sales between $500,000 and $1,000,000	10
Broadcasting stations with time sales of $1,000,000 or more	15
Networks	12

In 1940 the imposition of these rates would have resulted in a gross tax liability of approximately $10,000,000 or slightly less than one-third of net income before Federal income tax. The percent of net income represented by the above rate schedule would have ranged on the average from 18.3 percent for stations with net time sales between $100,000 and $500,000 to 40.2 percent for those with net time sales of over $1,000,000.[6] In the case of the networks, the resultant tax would have equaled 48 percent of net income. It should be kept in mind, however, that this has reference to net income derived from network operations as distinct from station operations.

TABLE 3.—*Combined broadcast service-income statement of 8 networks and 765 standard broadcasting stations—1940*

	Major and regional networks	Broadcast stations with time sales in excess of $100,000 each	Broadcast stations with time sales less than $100,000 each	All reporting broadcast stations and networks
1. Number of units	8	225	540	773
Income				
2. Sale of time to networks		$26,605,716		
3. Sale of time to others		58,702,380		
4. Total sale of time	[1] $45,194,260	85,308,096	$24,321,431	$154,823,787
5. Deduct: Commissions and outpayments (none payable by stations on network time)	11,146,484	9,209,401	503,133	20,859,018
6. Balance, net time sales retained	34,047,776	76,098,695	23,818,298	133,964,769
7. Add: Incidental revenues	5,506,918	6,468,667	1,206,363	13,181,948
8. Total broadcast revenues	39,554,694	82,567,362	25,024,661	147,146,717
Expenses				
9. Total broadcast expenses, including all items of direct and indirect expenses but not including Federal income tax	31,042,634	58,511,478	24,295,897	113,850,009
Broadcast service income				
10. Net income before Federal income tax	8,512,060	24,055,884	728,764	33,296,708

[1] Before commissions and after outpayments.

Source: Federal Communication Commission, unpublished and confidential.

TABLE 4.—*Net income (before Federal income tax) as a percent of net time sales, 1940*

Net time sales classes	Net time sales	Net income before Federal income tax	Net income as a percent of net time sales	Number of units
			Percent	
Less than $100,000	$24,321,431	$728,764	3.0	540
$100,000 to $150,000	5,708,125	1,260,029	22.1	48
$150,000 to $200,000	5,946,529	1,562,454	26.3	37
$200,000 to $250,000	4,739,747	1,298,978	27.4	23
$250,000 to $500,000	20,761,352	6,009,322	29.0	67
$500,000 to $1,000,000	26,651,476	9,336,703	35.0	42
$1,000,000 and over	12,301,466	4,587,798	37.3	8
Networks	34,047,776	8,512,060	25.0	8
Total	134,497,902	33,296,708	24.8	773

Source: Federal Communications Commission unpublished and confidential.

[6] For corresponding percentages by more detailed time sales classes see table 5.

TABLE 5.—*Effect of excise tax on broadcast stations by size of time sales classes, and on networks, 1940*

	Stations [1] with time sales of—						Networks	Total
	$100,000 to $150,000	$150,000 to $200,000	$200,000 to $250,000	$250,000 to $500,000	$500,000 to $1,000,000	$1,000,000 or more		
Number of units	48	37	23	67	42	8	8	233
Net time sales	$5,708,125	$5,946,529	$4,739,747	$20,751,352	$26,651,476	$12,301,466	$34,047,776	$110,146,471
Total broadcast revenue	$5,939,381	$6,250,506	$5,092,517	$22,121,456	$29,296,119	$13,867,383	$39,554,694	$122,122,056
Net income, before Federal income tax	$1,260,629	$1,562,454	$1,298,978	$6,009,322	$9,336,703	$4,587,798	$8,512,060	$32,567,944
Excise-tax rates (percent)	5	5	5	5	10	15	12	
Excise-tax liability	$285,406	$297,326	$236,987	$1,037,568	$2,665,148	$1,845,220	$4,385,733	$10,453,388
Excise-tax liability as percent total broadcast revenue (percent)	4.8	4.8	4.7	4.7	9.1	13.3	10.3	8.6
Excise-tax liability as percent of net income before Federal income tax (percent)	22.6	19.0	18.2	17.3	28.5	40.2	48.0	32.1
Net income after excise-tax liability	$975,223	$1,265,128	$1,061,991	$4,971,754	$6,671,555	$2,742,578	$4,426,327	$22,114,556

[1] Excludes stations owned, operated, or managed by networks.

Source: Federal Communications Commission, unpublished and confidential.

The net burden on the industry and the net revenue to the Federal Government would have been substantially less since the imposition of the excise tax would have reduced the tax base for purposes of the net income tax and the excess-profits tax.

Even after the imposition of the above tax rates the broadcasting industry would have been left with a very high rate of return on investment. This is apparent from the following:

Tax liability in relation to invested capital,[1] on the basis of 1940 data

	Stations with time sales of less than $100,000 each	Stations with time sales in excess of $100,000 each	Networks (for network operations)	Grand total
Excise-tax liability	.....	$6,367,656	$4,085,733	$10,453,389
Net income before Federal income tax	$728,704	$24,055,884	$8,512,060	$33,296,708
Net income after excise tax	$728,764	$17,688,228	$4,426,327	$22,843,319
Invested capital	$20,992,952	$40,308,752	$13,276,831	$74,638,535
Net income after excise tax as percent of invested capital, percent	3.47	43.82	33.34	30.60

[1] Invested capital includes the cost of tangible property less the depreciation taken, plus intangible broadcast investment plus reasonable working capital requirements.

Source: Federal Communications Commission; unpublished and confidential.

Although the industry would appear to be well able to pay from its net income an excise of the magnitude considered, it is not likely that it would do so. It is probable that in the space of 2 or 3 years a part of such a tax if enacted, would be passed on to the advertiser.

The principal broadcasters who conduct a large part of the business and earn a large part of the profits operate in the densely populated areas under conditions approaching monopoly. This would suggest that they already charge optimum rates for the sale of time, resulting in a maximum return to the industry. This circumstance, together with the fact that the rates now charged for the sale of time are those dictated by the competitive rates of newspaper advertising, suggests that any tax imposed on the broadcasting industry would not affect prices and would be absorbed by the industry out of profits. Other considerations, however, suggest a different conclusion. The broadcasting industry is still in its developmental stages. Those charged with its management have neither the information nor as yet have had sufficient time to fully exploit their monopolistic positions. There are some indications that the industry had adopted a waiting attitude pending further development and a stabilization of the Government's regulatory policy. This suggests that the imposition of a relatively heavy tax might prompt broadcasting management to exploit more fully the potentialities of the industry. In this process at least a part of an excise tax would be shifted to advertisers and ultimately to the consumers of the advertised products.

(The following letter was ordered incorporated in the record at this point:)

ALVORD & ALVORD,
Washington, D. C., August 17, 1942.

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: The National Association of Broadcasters respectfully invites the attention of your committee to the testimony and memoranda submitted to your committee during its hearings on the revenue bill of 1941 (hearings, pp. 726, 740, 741, 1476) and to the Committee on Ways and Means this year (hearings, pp. 3298–3309), in opposition to the suggestion, which Mr. John B. Haggerty has again made, that a special tax be imposed upon the radio industry.

The association also desires, as a matter of record, to summarize briefly the conclusive replies to Mr. Haggerty's statements:

(1) The Treasury has not recommended and is not recommending (jointly with the Federal Communications Commission or otherwise) the adoption of a special tax upon the radio industry. (See letter of Randolph E. Paul, General Counsel, Treasury Department, to Hon. Walter F. George, dated August 13, 1942—hearings before the Committee on Finance, p. 721).

(2) The proposed tax is not supported by labor generally. Mr. W. C. Hushing, of the legislative committee of the American Federation of Labor; Mrs. Emily Holt, of the American Federation of Radio Artists; and Mr. Lawson Wimberly, of the International Brotherhood of Electrical Workers, are among the witnesses who appeared on behalf of labor before the Senate Committee on Finance and the Committee on Ways and Means in opposition to the proposition.

(3) The proposed tax would seriously jeopardize the extraordinary and commendable contribution to the Nation's war effort which radio is now making.

(4) There is no justification for the imposition of a discriminatory tax of this nature upon any industry, and most certainly not an industry engaged in the dissemination of facts and information.

We trust that your committee will again reject any proposal to impose a special tax upon the radio industry; and we are confident that your committee will afford the industry and others interested an adequate opportunity to be heard in the event that any plan (such as the plan prepared jointly by the Federal Communications Commission and the Treasury Department and which was submitted without recommendation as to its adoption in the letter from Mr. Paul, dated August 13, 1942, above referred to) is under consideration by your committee.

Respectfully,

NATIONAL ASSOCIATION OF BROADCASTERS,
By ELLSWORTH C. ALVORD,
Counsel.

(The following communication was ordered inserted in the record:)

MEMORANDUM BY MILLARD REECE, BRUNSWICK, GA., IN CONNECTION WITH THE PROPOSED REVENUE BILL FOR 1942 NOW PENDING BEFORE THE UNITED STATES CONGRESS

I. INTRODUCTORY REMARKS

All citizens of our country realize that money will have to be provided to maintain and carry to a successful conlusion the stupendous war in which the Nation is engaged.

All of us realize that existing taxes will have to be raised and new taxes will have to be imposed, and that the number of taxpayers will be increased.

The tax structure has grown so complicated that it not only is a question of paying the multitude of taxes that have to be paid. On the part of taxpayers there is involved the burden and expense of keeping records and filing reports and even individuals with modest incomes find it necessary to employ at annual intervals certified public accountants to review and correct these records and to make out their returns.

On the part of the Government, every amendment to or enlargement of an existing law which creates a larger number of taxpayers, and every new law imposing a new tax, make it necessary for more men to be employed to handle, investigate, and verify the returns, collect the tax, assert claims for underpayments and pass upon claims for refunds. The increased governmental expense constitutes an additional tax upon the taxpayers. Not only so but other expenses and burdens are involved to the Government. For instance, added burdens are placed upon the mails and the Government Printing Office.

The time has been reached in the crisis through which the Nation is passing when man-hours should be conserved, and all materials and supplies and all transportation capacity that may be saved should be saved.

It may be doubted if any of us, even including the men who hold the most responsible administrative positions in our war effort, appreciate fully the extent to which private production for private consumption has dwindled or will dwindle. Both private and public production for governmental use has increased to a startling exten and will continue to increase.

With the Government and governmental agencies consuming such a large percentage of the total production of the country, and employing directly or indirectly such a large proportion of those gainfully employed, we are fast reaching the point where the Government not only is the tax gatherer but, in effect, incomparably the largest taxpayer. This means, when properly analyzed, that a large percentage of the national revenue for 1942 and later years will not represent revenue to the Government in the true sense, but actually will represent nothing more than a recapture by the Government of a comparatively small part of the enormous expenditures the Government is having to make. Expressed in another way, this

means that the Government will reclaim only a percentage of the dollars that might have been saved if our economic order were based upon a high rather than a low dollar value.

Another thing that has to be borne in mind is the severe readjustments the war effort already has caused among many lines of private business. Perhaps the most striking of these occur in the automobile and related industries. Many automobile dealers, filling-station operators, distributors of accessories, and others who have been accustomed to pay income taxes either will have none to pay or the amount will be much less, considering the higher rates.

With these considerations in mind, it is submitted that in framing our first wartime revenue measure the following purposes should be preeminent:

1. To increase the revenue by as large a total amount as may be possible without crippling the war effort and without reducing any more than is absolutely necessary the ability of private enterprise to pay the taxes imposed and still keep going. In this connection it has to be remembered that very much larger revenue will be needed in future years than in the past, even after a successful conclusion of the war. No greater mistake could be made than for the 1942 revenue law to extract from taxpayers the last possible dollar that might be extracted in 1942 and 1943.

2. To frame the revenue measure so as to make it (*a*) as simple as possible, and (*b*) to reduce the cost of its operation in man-hours, materials, and services, both to taxpayers and Government, as much as possible.

II. INCREASE AND ENLARGEMENT OF INCOME TAX

Unquestionably the income tax will have to be increased in rates upon those liable to the tax under existing law.

Unquestionably it also is true that personal exemptions may have to be lowered and a large number of new taxpayers brought within the operation of the law, unless some other form of taxation should be adopted under which small earners would have to contribute to the fair extent of their ability.

If exemptions are to be lowered it seems necessary also to provide some system of withholding the tax at the source. This is true primarily to insure the collection of the tax from those earners who have not been accustomed to make returns in previous years and many of whom no doubt are improvident and would fail to make provision for payment during 1943 of the tax imposed for 1942.

Secondarily, this would result in the collection of the 1942 tax or a portion thereof during that year. This latter result has its advantages as well as its disadvantages. Under the basic conception of the income tax it is not sound fiscal policy to anticipate by one year the collection of revenue to be derived therefrom. It would impose an undue hardship on persons who have to pay in 1942 tax on their taxable income of 1941 also to have to pay during the same year an additional year's tax or a substantial part thereof. And it must be borne in mind that many taxpayers are not sharing in war prosperity, directly or indirectly, and will have smaller incomes during 1942 than in 1941 and previous years.

To require all taxpayers or the new taxpayers to make payments during 1942 deducted at the source against the regular income tax, and in 1943 to file regular income-tax returns for 1942 showing amounts previously paid, is unthinkable to me. This would involve an immense cost in man-hours and money. The Government would have to employ men or women to review, check, and correct these returns and to verify credits claimed for payments deducted at the source. This would involve much more work than reviewing and checking the ordinary return of an individual taxpayer. No doubt many instances would occur where the taxpayer would be entitled to refunds of from 1 penny up. And the meticulous way in which the Government handles money transactions would require such refunds to be made, unless the law itself should fix a minimum over- or under-payment for which no adjustment would be made.

Some substitute plan should be found. The following is suggested for consideration:

1. Let a pay-roll tax be imposed as an income tax and in lieu of the regular income tax and provide that it be collected and paid by the employer just as social-security taxes are collected from employees and paid. Let it constitute the entire

income tax for which the employee will be liable. Ignore exemptions in a fixed amount per year. Take care of the matter of exemptions in the rates fixed.

2. A person who made returns and paid tax for the years 1940 and 1941 should be exempt from the operation of this phase of the law, and not only permitted but required to make a regular return.

3. Fix the amount of tax at a percentage of the full amount of wages or salary paid. This should be done to make the calculations as easy as possible, and thus lighten the work of the one who prepares the reports as well as the Government agents who check them.

4. The suggested tax should not apply above a fixed maximum weekly wage and its equivalent monthly wage. Payments should be by the quarter and the average for the quarter should control. Where the first quarter of a given year placed a taxpayer within the operation of the law and a subsequent quarter showed earnings above the maximum fixed, one of two provisions would have to be made, namely, either (*a*) that the taxpayer should continue to pay the pay-roll tax during the rest of the tax year, or (*b*) he would be required to report the following year on the regular basis, taking credit for the pay-roll tax deducted. If (*a*) applied the rate should be increased upon the amount earned above the maximum average.

5. It would not be necessary, perhaps not proper, to make this pay-roll tax the exact or even approximate equivalent of the regular income tax imposed. At least a quasi precedent for different treatment exists in the present law where a person whose gross income is not more than $3,000 may make a return on a basis of gross income instead of net at his option. But, of course, it is not a full precedent as a taxpayer falling within the additional pay-roll tax would not be permitted an option.

6. A pay-roll tax payer having other income would have to be required to make a regular return, claiming credit for pay-roll deductions.

III. SALES TAX

It seems to me it would be decidedly better to have a well-thought-out sales tax than to undertake to enlarge the income tax to the extent now proposed, or to adopt the pay-roll tax suggested in II above.

If income-tax exemptions should be kept as they are now, it seems this should answer any real basis for criticism of a sales tax against the necessaries of life. Those who are not income-tax payers would have no just complaint if the sales tax would be the only tax directly affecting them.

Here again the matter of the machinery of collecting the tax should be made as simple and as inexpensive as possible. The following thoughts are submitted in connection with a sales tax:

1. It should be imposed only on goods and commodities sold for distribution and consumption by the general public—commodities sometimes called "consumer goods."

2. The retailer should not have the burden and obligation of collecting the tax and paying it over to the Government. This burden and obligation should be placed upon the manufacturer or importer of consumer goods when making sales to a jobber, retailer, or anyone else. If restricted to manufacturers and importers the machinery required for the collection of the tax would be much less elaborate. A small army of Government employees would be required to check, and enforce collection of, a sales tax imposed against the public to be collected and paid the Government by retailers. Even then a considerable portion of the tax never would be collected, or the cost of collecting it would be more than its value.

Not only would the Government have to deal with a much smaller number of taxpayers but upon the whole with a more responsible class.

The nuisance of using metal "tokens," common in States having a sales tax, would be avoided.

3. The very basis of the tax suggested would avoid one criticism that frequently is made of such a tax. So long as products of the farm are in their original state they would not be covered by the tax. But if fruits and vegetables were canned or otherwise processed, sales of such commodities would be taxed.

4. Other exemptions should be few. Commodities already carrying heavy specific taxes, such as gasoline, cigarets, liquors, etc., should be exempt. As a matter of expediency as well as public policy, newspapers and magazines should be exempt, and perhaps books as well, but the things going into their making,

such as paper and printer's ink, should carry the tax. Perhaps the more essential drugs should be exempt.

5. Since the tax would operate only against consumer goods, of course only one tax would be imposed, regardless of the number of manufacturing processes that might be employed before a given article would reach the ultimate consumer. For instance, I have no idea how many manufacturing processes are employed before the cotton that goes into a shirt finally becomes a shirt. It would be only after this cotton was in the form of a shirt and the shirt was sold by the manufacturer that a tax would be paid.

6. Difficulties and complications would arise of course. You know much better than I how impossible it is to frame a tax act where difficulties and complications do not arise. As an illustration, a manufacturer might sell flour to a jobber or retailer. The jobber or retailer in turn might sell it to a baker. The baker would make it into bread and sell the bread either to retailers or to consumers. No doubt other instances of the sort would develop. Special treatment would have to be provided for each such case. In case of the baker my thought would be the tax should be collected in the ordinary way, and his products should be exempt. In other words, he should not be treated as a manufacturer.

7. If the tax should be imposed and collected as suggested it necessarily would have to be at a higher rate than if imposed upon sales by the retailer and collected by him. This necessarily is true because the manufacturer's prices are lower and cost of transportation always is involved between manufacturer and retailer. And so if a 2 percent tax on retail sales would be right, to produce the same amount of revenue this would have to be raised, probably to 3 percent, against manufacturers.

IV. SICKNESS EXEMPTIONS

Even since the first income-tax law was passed I have felt that a reasonable exemption should be allowed, certainly to those with modest incomes, for the expenses incurred by reason of sickness or invalidism of the taxpayer or his dependents. In letters written you this year my views on this subject have been stated quite fully. They will not be repeated here, further than to say this:

With the lowering of personal exemptions already made effective, and with consideration being given to the suggestion to lower such exemptions still further, it becomes a matter to which Congress should give careful consideration. So long as the personal exemption for a married man stood at $2,500 the group of earners most concerned was not particularly affected, for those entitled to greatest consideration are married men whose incomes are not in excess of $2,500 or $3,000.

But with the exemption for married men already cut to $1,500, and with the practical certainty that it will be cut to some lower amount under the 1942 act, certainly some relief should be given.

With the higher cost of living that prevails and the higher taxes that will be imposed, the relief certainly should be extended to those whose net income is not more than $2,500 and it would not be unreasonable to extend it even as high as $3,000.

Where the taxpayer may have insurance covering hospitalization and other expenses of sickness, it would be proper to require him to credit the amount of insurance collected against the exemption.

V. CONCLUSION

To summarize what has been said, my own views are:

1. Income-tax rates should be increased, particularly on individuals. While the rates agreed upon by the Ways and Means Committee of the House of a normal tax of 6 percent and a surtax commencing at 12 percent and advancing rapidly are severe and drastic, in my opinion they are not too high in the real emergency now existing.

2. A sales tax on consumer goods to be collected by manufacturers and importers and by them paid to the Government is preferable to reducing personal exemptions under existing law, and thus broadening the number of taxpayers. The tax should apply upon the sale of all consumer goods manufactured or processed, with the exception only of such goods already carrying heavy excise

taxes, newspapers and magazines (and perhaps books), and essential drugs. This tax would fall upon rich and poor alike.

3. Unless a sales tax should be passed it is realized that personal exemptions will have to be lowered so as to bring many small earners within the operation of the law. Special handling should be given this class of taxpayers so as to have the tax imposed collected at the source. The tax would constitute a payroll deduction and should stand in lieu of the regular income tax. It should be paid as social-security taxes are paid.

4. Further than this I think it would be unfair to taxpayers generally to require collection at the source. Not only would this involve an inconceivable amount of man-hours and expense to employers, but it necessarily would enlarge severely employees of the Internal Revenue Service. In addition to these consideration it would throw upon taxpayers affected payment of more than 1 year's taxes within the year. The tax burden already is heavy and this in and of itself would work a great hardship on many taxpayers.

5. If existing personal exemptions should be reduced an additional exemption of not less than $500 per year should be made for expenses of sickness or invalidism incurred by a married taxpayer whose net income, without such deduction, would not exceed $2,500 per year, and if personal exemptions should not be reduced, then such an exemption should be allowed to a married taxpayer whose net income without that exemption is not more than $2,000 per year. Such exemptions should be reduced by the amount received by the taxpayer from insurance coverage.

Respectfully submitted.

MILLARD REECE.

MAY 28, 1942.

The CHAIRMAN. Mr. Walters?

STATEMENT OF AUGUST WALTERS, NEW YORK, N. Y.

Mr. WALTERS. Would you grant me permission to appear tomorrow morning? I think you are too tired to listen to me tonight. It is so important.

The CHAIRMAN. We have more witnesses tomorrow than we have had today. If you will take your chance and go to the foot of the class tomorrow.

Mr. WALTERS. At the foot of the class tomorrow?

The CHAIRMAN. Yes.

Mr. WALTERS. I thought you would put me at the head of the class.

The CHAIRMAN. We can't do that, because we have a large number of men coming in tomorrow. If you want to file a brief you are privileged to put it into the record.

Mr. WALTERS. I will tell you: I can prove to you that with the finance plan which I will respectfully submit I can save the Nation $100,000,000,000.

Senator CONNALLY. How much?

Mr. WALTERS. $100,000,000,000, at a cost of $2,000,000,000.

The CHAIRMAN. Two billions?

Mr. WALTERS. Yes, sir. It will cost you only $2,000,000,000 to finance $100,000,000,000 worth of bills.

Senator CONNALLY. Let's hear him now.

Mr. WALTERS. Is that interesting?

The CHAIRMAN. Yes.

Senator CONNALLY. Get up here, closer.

The CHAIRMAN. We want to see how it works.

Mr. WALTERS. We the people own $12,000,000,000 of paper and silver currency which is deposited in the banks of the Nation. The bankers have the free use of this money. We the people furnish the bankers

with $12,000,000,000 worth of capital which costs them nothing. They invest this money in stocks and bonds and pocket the profits which they derive from this capital.

Now, I say, if the bankers have the privilege to use the people's money and our national credit direct, why should not the Government have the same privilege.

Am I right?

All right. Now, let me illustrate the passage of one check. A contractor has received a check for $2,000, made out by the Treasury Department, payable at a Federal Reserve bank. The contractor goes to the bank and says to the teller, "Let me have cash." The teller hands him $2,000 in cash out of the people's deposits.

The minute this Treasury check has been turned in and the money paid out the banker says: "The Government owes me $2,000."

He demands a bond and he gets it.

Now, the contractor goes as far as the door of the bank, and he says to himself: "Why should I carry $2,000 in my pocket?"

He turns around, he redeposits the money he just received from the teller, and receives a bank book and a check book, but the bond remains.

The Government of the United States has gone $2,000 into debt.

One banker told me, "When Mr. Walters has the bankbook and the checkbook he will draw out that money some other time."

True enough. No matter when that money is drawn, the money used at that time is the people's money and the banker has not lost 1 cent.

Now let me tell you how this can be done, under the plan which I call the national participation bank plan, because all the people participate in financing the governmental budget: The contractor gets a check made out by the Treasury Department for $2,000. He goes to the bank and he says, "Let me have cash." He gets the cash, or turns it in again and receives a bankbook and a checkbook, but in view of the fact that the banker has rendered a national service by cashing this check, he is entitled to be paid for this service, and I suggested in my treatise to pay the banker a 2-percent service charge for cashing or crediting this check.

The banker makes an honest profit of $40 on this single transaction; instead of going $2,000 into debt we paid $40 to pay a bill of $2,000.

If we multiply this and pay $100,000,000,000 worth of bills the service charges to the bankers would be $2,000,000,000.

Senator TAFT. What does the banker do with the check that he gets from the bank?

Mr. WALTERS. Now, this is a Treasury check. The banker returns the check to the Treasury Department where he receives credit for $2,000.

Now, the free use of money has enabled us to pay $100,000,000,000 worth of bills at the cost of $2,000,000,000; is that right?

Senator TAFT. If the bank has the $2,000 credit of the Government, they can take the $2,000 and buy a bond with it, with just the same result.

Mr. WALTERS. Pardon me, Mr. Senator; we don't need to buy any more bonds under this plan.

We can finance the entire war cost and the entire Budget under this system.

For instance, it would be like this——

The CHAIRMAN. Well, off the record.

(Discussion off the record.)

Mr. WALTERS. We go into debt at the present time.

Senator TAFT. If you give the bank credit you are going into debt, too.

Mr. WALTERS. There is a great difference—between paying interest on a war debt and giving a man credit on the book.

Senator TAFT. You save money by not paying any interest on the debt?

Mr. WALTERS. That is only one item I save the Nation. It would be like this: Supposing I have a hundred thousand dollars at home. I made up my mind to leave the country for 3 or 4 years. One of you gentleman has a safe, and I say to you, "Would you be so kind as to keep my money while I am gone?" I make no restrictions.

I say, "Give me a receipt and when I come back you hand me back the money."

A few days later you meet somebody who says to you: "I could use a hundred thousand dollars. I have a wonderful investment," and you think of the money which I left with you.

You say, "Well, all right. I will investigate this matter."

You find he has really a wonderful security, and you loan him my money.

Now, that may go on for 2 or 3 years. You make twelve to eighteen thousand dollars of profit, simply due to the fact that I entrusted you with my money.

I am not asking you any interest; I simply want my money back.

Consequently, all your expenses—maybe household expenses—you pay with the money you make out of my money, and it costs you nothing to run your household.

It that true? Would that be true under those circumstances? Would that be true?

That would be a profit in your pocket which would cost you nothing.

The CHAIRMAN. Suppose the man didn't pay you back the hundred thousand?

Mr. WALTERS. That is a different story.

The CHAIRMAN. I know it is a different story.

Mr. WALTERS. The banks at the present time are in exactly the same position.

All we ask of the bank is not to lose our money, but we give them the privilege to use it.

Senator CONNALLY. Let me ask you, how would the Government save any money on that $2,000, if the banker took it over to the Treasury and got credit there? That would mean that the Treasury would have to pay him the $2.000 whenever he wanted it.

Mr. WALTERS. True enough.

Senator CONNALLY. How would there be any saving there?

Mr. WALTERS. We could control credits, and we don't pay any interest.

Senator CONNALLY. Well, I know. You said it had other advantages.

Mr. WALTERS. That would amount to five or six billion dollars in the future.

Senator CONNALLY. How would you save ninety-eight million out of a hundred by going over there and giving him credit out of the Treasury? because the credit is worth nothing unless you expected to be paid for it.

Mr. WALTERS. You can control it just the same. If these credits would pile up you tax everything out of existence the same as you want to tax everything out of existence right now.

Suppose I illustrate this with the Post Office Department. In view of the fact that the capital costs Uncle Sam nothing, the free use of the money costs Uncle Sam nothing, if we paid the expenses of the post office, like ink, paper, wages, and all that, with the free use of the money all income from the post office would be a clear profit to Uncle Sam, and that is at the present time approximately $1,000,000,000.

Supposing we use that same system with every revenue department in the United States Government—instead of creating debts, every revenue department would create a profit for Uncle Sam, and for that reason you can limit Federal taxation to $10,000,000,000 a year.

That $10,000,000,000 a year would be clear profit to Uncle Sam.

Now, what do we have to pay out of the $10,000,000,000? The first item to pay would be the banker's service charge of $2,000,000,000.

That would leave $8,000,000,000 in the Treasury of the United States.

The next item would be to pay the people interest on their money, because the people have given Uncle Sam the privilege to use their money, and we could pay the people 4 percent interest, which would be $2,000,000,000, if the deposits of the people in the savings bank would be $50,000,000,000.

Well, all right. We have $2,000,000,000 to the bankers, $2,000,000,000 to the people.

That would leave us $6,000,000,000 of actual money in the Treasury instead of going $100,000,000,000 into debt.

You still have $6,000,000,000 left. You could finance the Red Cross; you could finance every calamity that would hit the people, like fires, earthquakes, floods, shipwrecks.

Supposing that would cost another billion dollars—you have $5,000,000,000 left in the Treasury, and that could be used to start payments on the national debt.

Now, gentlemen, just consider this plan seriously. It is absolutely safe and sound. It is nothing else but the privilege which the bankers enjoy today.

The CHAIRMAN. Thank you very much, Mr. Walters.

Senator CONNALLY. A very ingenious plan.

Mr. WALTERS. One of the biggest bankers in New York told me the same thing. He said, "I hope you make it a success with the Senate."

Why not consider it. You could start out with one department, Honorable Senator.

The CHAIRMAN. Yes, sir. We are pleased to have your views. We will recess until 10 o'clock tomorrow.

(Whereupon at 5:23 p. m., the hearing was recessed, to reconvene at 10 a. m., Tuesday, August 4, 1942.)

REVENUE ACT OF 1942

TUESDAY, AUGUST 4, 1942

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

The committee met at 10 a. m. pursuant to adjournment, in Room 312, Senate Office Building Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will come to order, please.

Senator Brown, there are two witnesses that you wanted to have heard. Do they wish to be called now?

Senator BROWN. I think Senator Van Nuys would like it if they would be heard now; that is, Mr. Colerick and Mr. McKinney.

Senator VAN NUYS. They will be here in about 5 minutes.

The CHAIRMAN. We will call them within a few minutes.

Senator CONNALLY. Mr. Chairman, yesterday, Governor Hobby failed to appear. It will not take over 2 or 3 minutes for him to present his statement. Would you hear him now, or would you rather have him later in the day?

The CHAIRMAN. If it is agreeable, Senator, we will hear Governor Hobby. I just had a note that he was here this morning.

Senator CONNALLY. That is perfectly agreeable.

The CHAIRMAN. Come around, Governor Hobby. We would be very glad to hear from you.

STATEMENT OF FORMER GOVERNOR OF TEXAS, HON. W. P. HOBBY, PUBLISHER OF THE HOUSTON POST

Mr. HOBBY. My name is W. P. Hobby, Houston, Tex., publisher of the Houston Post.

Mr. Chairman and gentlemen of the committee, I assure you what I say will not be long; it will have the soul of brevity.

I have read with gratification press reports that Senator Walter F. George, your chairman, strongly urges inclusion of a provision in the 1942 revenue bill which will make it possible for businesses and individuals to pay something on their debts under heavy taxes which must be levied to finance the war.

I note with gratification, too, that the Treasury is reported to be writing a formula by which debt retirement may be carried on in an orderly manner under necessarily heavy wartime taxation.

These hopeful developments have greatly encouraged businessmen in Texas, many of whom face ruin or extreme hardships, and in whose behalf I appeared before the Ways and Means Committee of the House to urge inclusion in the tax bill of a debt-relief provision. The House

committee received these suggestions in a friendly and understanding spirit and failed to act on them, I am informed, solely because time was lacking at the end of its deliberations, and it was felt the Senate would give this matter further attention without delaying final enactment of revenue legislation.

It is not my purpose to burden you now with technical or lengthy arguments.

Briefly, there are thousands of businesses in this country which have no war contracts and no expectation of getting war contracts. In most cases these businesses have lost revenue or will lose revenue through imposition of wartime economic controls over prices, production, and distribution of goods. As the war continues, they can anticipate only increasing difficulty and growing losses.

These are small corporations with limited resources. Prior to imposition of heavy income taxes, they borrowed money for expansion of their businesses, for payment on the purchase of business, for improvements or betterments, renewal of machinery, and similar purposes.

These debts were incurred under the reasonable expectation of repaying them from earnings. When the money was borrowed, no one knew would be plunged into war which would make necessary the greatest spending and taxation program in our history.

When many of these businesses borrowed money, 15 percent of their earnings went to the Federal Government for income taxes. Under the 1942 revenue bill as passed by the House, normal income tax and surtaxes take 45 percent of earnings and excess-profits taxes up to 90 percent.

It is obvious that under these rates, despite the most careful and prudent management, nothing will be left in many cases for paying debts incurred in good faith and which under normal conditions could have been amortized from earnings without difficulty.

I explained before the House committee that with many of these businesses it is a matter of life or death. I pointed out that owners and operators of these businesses were not seeking favors or concessions but only the right to survive.

This, in a sentence, is our request:

> Leave us something with which to pay our debts and operating expenses and let the Government take the rest of our earnings to finance the war.

Merely as a suggestion, I said this to the House committee:

> If you will allow in the new revenue law a credit for money actually paid on debts incurred prior to January 1, 1940, by those businesses not enjoying war contracts, the credit not to exceed 5 percent of the total debt in any 1 year, and to apply on that portion of income subject to surtaxes and/or excess-profits tax, I think you will have a formula which will not hurt the Treasury but really help it in the long run and at the same time prevent a sentence of death being passed on thousands of businesses in this country.

My idea that the debt deduction should be allowed only out of surtaxes and excess profits is based upon the fact that businesses incurring indebtedness might have expected a reasonable increase in the normal tax, but the exorbitant percentage that surtaxes and excess-profits taxes call for could not have been anticipated, and therefore justifies a credit allowance.

Since my appearance before the House committee, testimony before your committee has revealed that even flourishing way industries

whose Government orders are doubled and tripled in a week are finding it difficult to finance borrowing for necessary plant expansions.

If these businesses find themselves in trouble, you may well imagine how much greater are the difficulties of non-war businesses with heavy pre-war indebtedness.

The first objective of the American economy must be, of course, to win the war. To achieve that the American economy must, in my opinion, remain a going concern, capable of paying taxes, providing work for people who also can pay taxes and buy Government bonds. As I interpret official statements and pronouncements, every business is expected and urged by the President to pay off during this war as much indebtedness as possible so the business may be financially strong when the war is over.

The debt relief provision for which small business pleads is in line with this objective. It will enable business to survive. It will keep men and women working so they can help pay for the war. It will establish an arrangement for the duration of the war which will enable both business and financial agencies to know the conditions under which they must operate. And it will create a sound and workable pattern for American wartime economic life which can stand on its own feet during the entire conflict without change.

The problem is one that must be met sooner or later. Meet it now in time to prevent small business from being forced to the wall and that war problem is out of the way. If you meet it now you will save the businesses which must have this relief. If delayed, these taxpayers will be lost to the Treasury.

The CHAIRMAN. Any questions, gentlemen?

Senator DANAHER. I would like to know, Governor, why you say the credit should not exceed 5 percent of the total debt in any one year?

How did you happen to hit on that particular percentage?

Mr. HOBBY. I just considered that most businesses could amortize their debts on a 20-year plan and if that were the case, 5 percent a year would enable them to carry on that amortization.

I am not student enough to know that that is the best plan, but it was just my plan, and that is the way I have hit upon it.

Senator DANAHER. You do not try to relate it to the tax rate at all?

Mr. HOBBY. Not at all. It was just what I thought was a reasonable deduction and one that would fit in the line of amortizations frequently made for 20-year payments, and if that 5 percent was deducted, it would be so small that it would be less felt by the Treasury than if it were a larger amount.

Senator DANAHER. Would you give about the equal amount of credit to an individual or a business which was not in debt?

Mr. HOBBY. Well, I do not think one that is not in debt is in any trouble, except this, I think, if my theory is correct and my idea is correct about it, what I am talking about affects the whole business structure, the credit system of the country. To keep business going is as important to the man or concern that does not owe money as it is even to the man who does.

The CHAIRMAN. Your idea is he can apply a similar amortization?

Mr. HOBBY. Yes.

The CHAIRMAN. The American taxpayer who is in debt is able to maintain his credit standing.

Mr. HOBBY. Exactly, and the man who does not owe money is not hurt by that.

The CHAIRMAN. I fail to see that it creates any tremendous inequity myself, although there should be ways in which we might preserve the equity between taxpayers.

Senator CONNALLY. Just one question.

Mr. HOBBY. Yes.

Senator CONNALLY. Governor Hobby, I understand you to say that you publish a newspaper.

Mr. HOBBY. Yes.

Senator CONNALLY. Am I correctly informed when I am advised that the newspapers have lost, on account of priorities and war regulations, a great deal of their advertising and other income?

Mr. HOBBY. Newspapers, Senator Connally, have been hit hard in the loss of their revenue, because the automobile and tire advertising alone, I expect, will run 20 percent of the average linage of a newspaper in our city, and in all cities.

It puts those advertisings out, and there is every reason to believe that others will go out. The last we heard, we were going to lose these beer advertisers, and there will be others—there will be other lines.

Senator CONNALLY. National advertising has generally fallen off in local papers?

Mr. HOBBY. Very much; very greatly.

Senator CONNALLY. All right, that is all.

Senator TAFT. Governor Hobby, don't you think the limitation would have to be on the percentage of net income or gross income rather than debt?

Mr. HOBBY. I have noticed that suggestion. It may accomplish the same purpose, Senator.

Senator TAFT. It seems to me, ordinarily, people pay their debts more in accordance with their ability to earn money than they do anything else. I should think that any banker as long as he is being paid something, in some proportion of what the company is able to pay, could not object very well to spreading the amortization.

Mr. HOBBY. I think that that would very likely accomplish the same purpose that I have in mind.

Senator BYRD. Governor, I understand you propose to make this deduction only for existing indebtedness, indebtedness that has occurred to this date.

Mr. HOBBY. That is correct.

Senator BYRD. What about any future indebtedness that may be necessary for the expansion of business or for any other purposes?

Mr. HOBBY. I think that would be fine.

Senator BYRD. But your present proposal is applied to existing indebtedness?

Mr. HOBBY. Yes; I think it would be a very wise thing, I think it would stimulate business in the country for improvement purposes. plant improvement, building, or anything else. The development would help business in a general way, it would stimulate trade.

Senator BYRD. Of course, you would have to safeguard that, because some companies may borrow money for the purposes of reducing their taxation in the future. I think there is a great deal of logic in your argument with respect to the existing indebtedness, and some logic

with respect to the future, because the taxation will be so great that perhaps these companies would not have the money for expansion which they may require.

Mr. HOBBY. I think it may come to the time when you gentlemen would consider it wise to do that on future borrowings.

Of course, what I am talking about I think is the most pressing need. Of course, you do not have as much opportunity for improvement of your plant and facilities now because it is hard to get what you need.

Senator BYRD. Have you given any consideration to the quick assets that a company may have? Suppose a company has a large cash reserve and also owes a debt but does not apply that cash to the debt? Should not that be considered in this deduction equivalent to 5 percent of the indebtedness in the taxation?

Mr. HOBBY. Well, Senator, I do not know about that. I imagine most of them have paid as much as they could and would have very little cash reserve. If they had the cash they paid most of the cash on the debts.

Senator BYRD. I think many prudent companies are trying to accumulate a cash reserve by reason of the uncertainties.

I only bring that out, because while I think there is a great deal in your theory, a good many details must be worked out.

Mr. HOBBY. I think that is correct.

The CHAIRMAN. Thank you very much, Governor.

Mr. HOBBY. Thank you, Senator, and all of the Senators.

The CHAIRMAN. The first witness scheduled this morning is Mr. McGovern, of the American Chamber of Commerce of Cuba.

STATEMENT OF MAURICE T. McGOVERN, HABANA, CUBA, REPRESENTING THE AMERICAN CHAMBER OF COMMERCE OF CUBA

The CHAIRMAN. Maybe we might shorten your testimony here on this point with this statement: I think it is recognized that the complete elimination of section 116 (a) was not really intended, that it was not the primary purpose in the case of the bona fide, nonresident American citizen who established a home and maintains his establishment and is taking on corresponding obligations of the home in any foreign country, but there is some need for treatment of this section, so that the technicians, American citizens who are merely temporarily away from home could be properly reached and properly dealt with for taxation purposes.

I make that statement to you in the beginning in the hope it might relieve some of the burden from you. We would be glad to hear from you on the problem that you wish to present this morning.

Mr. MCGOVERN. Thank you, Mr. Chairman.

My name is Maurice T. McGovern. I am a citizen of the United States and a resident of Habana, Cuba. I have been in business importing into and selling American products in Cuba for the past 25 years.

I shall not attempt to stick to my text, Mr. Chairman, because the points which you mentioned are the points which we were going to request for bona fide residents of foreign countries, American citizens interested in commerce, but may I point out a few things that I think would be interesting?

The CHAIRMAN. Yes. I am sure the committee would be glad to have you do so.

Mr. MCGOVERN. Perhaps some few statistics on foreign-born residents in Latin America might be helpful. This data is, of necessity, approximate. There are approximately 230,000 Germans and approximately 1,330,000 Italians in Latin America.

Senator VANDENBERG. What do you mean by "Latin America"? Do you mean the entire area in the Western Hemisphere covered by Latin American countries?

Mr. MCGOVERN. Yes; in all of the continent of South America the West Indies, and Central America.

Senator TAFT. And Mexico?

Mr. MCGOVERN. And Mexico; yes.

There are about 230,000 Japanese in Latin America, 150,000 French, and 200,000 British.

Senator VANDENBERG. What is the total population?

Mr. MCGOVERN. The total population is about 127,000,000, I believe. Of these there are 1,800,000 enemy nationals. There are only about 56,000 American citizens, men, women, and children, resident in Latin America, and of these there are perhaps 25,000 men like myself who spend most of their lives abroad in the foreign commerce of the United States.

They deal in a foreign currency, in a foreign language, and against foreign competitors under foreign laws, and they must all pay foreign taxes. They cannot vote, they do not participate in social security. They do not enjoy public-works programs, agricultural aid, or they are not entitled to unemployment relief, but they do ask that in the unequal fight they must carry on in foreign commerce, that no further handicap will be placed on them.

Citizens of England, Spain, Sweden, France, Canada, and Mexico pay no income tax to their home countries while residents abroad. It is considered common practice for Germany and Japan to subsidize their foreign commerce and many of their nationals individually abroad. No foreigner could come to the United States and pay all the American taxes, conduct a business in the United States, and then pay a substantial tax on his income to a foreign country and expect to continue competing in the United States.

Senator VANDENBERG. I would not think so.

Mr. MCGOVERN. And the converse is true with respect to the resident Americans abroad.

Income tax on American salaried employees working abroad would handicap them unfairly. While their salaries may, in some cases, be somewhat higher than for similar positions in the United States, their expenses frequently more than offset these increases in salaries. They pay higher prices for all American things which they and their families buy.

This increase is from 10 to 100 percent on automobiles, radios, refrigerators, shoes, stockings, suits, and American food.

Their local products are generally more expensive: electricity, gasoline, house rent, medical fees, hospital dues.

We pay 17 cents a gallon tax on gasoline in Cuba; we pay 34 cents a gallon for the gasoline. The education of their children in their local countries presents expenses far in excess of similar education in the

United States, and when their children return to the United States for preparatory school or college the total expenses per child per year are enormous. This proposed elimination of section 116 (a) will deprive many of these children of education in the United States and it will thereby deprive some of them of citizenship.

In foreign countries where there are no income taxes other taxes are usually excessive, and where there are income taxes recently inaugurated, those income taxes are usually small, but the other taxes are the important part of the country's revenues and an important part of the taxpayer's expense.

We believe that the public policy of the United States should encourage and not penalize this pioneer work, and that no steps should be taken as a part of our public policy to handicap our foreign commerce.

Americans abroad take risks regarding health. Even American insurance companies writing insurance abroad on Americans resident abroad, generally charge a higher premium for similar occupations than within the territory of the United States.

The civilian American resident in the United States is today enjoying full-time work and high wages in an atmosphere of controlled living cost, which permits him to pay appropriate income taxes.

The American in commerce, resident abroad, is today unable to get merchandise with which to carry on his established business in any volume which enables him to profit. He is making many sacrifices in increased living and business expense, whether in private business or working on a salary, to maintain the network of his markets open for the day when his communications are reestablished and against the day when he shall have the keenest of competition from world suppliers in the markets which he has cultivated.

I have been devoting my entire time for the past 30 years to foreign commerce, the last 25 of which I have lived abroad.

Frankly, the American foreign-commerce men abroad of 40 years ago, if viewed in cross section, left much to be desired. American firms trying to get men to go abroad had to employ semiadventurers; nobody else would consider work of that kind.

This condition continued until 1926, when section 116 (a), I. R. C., was introduced. The effect of this exemption was twofold: It offered some financial relief, but the most important was the effect on morale. The introduction of section 116 (a) served notice on the world, on the Americans abroad, and on the young Americans at home, that the United States had cast off its commercial isolation; that it was going to trade on the six continents and over the seven oceans; that our Government looked with favor on its men in foreign commerce.

Young Americans became pioneers again. Young college men and women prepared themselves; they went around the world and lived on the other side. They built commerce and friendship for America, and they carried progress, education, and enlightenment to the countries where they resided. In short, they benefited the Americans who remained at home and the natives of the country to which they went.

The American consulates and embassies soon found willing hands with whom to cooperate in carrying out their missions.

Resident Americans who knew the language, the country, and the people, men who could do things easily, things which the missions themselves, could not in any way accomplish.

Our chamber of commerce hopes that, in your study of this matter, you will find a way clear to assist these men in living abroad and in educating their children in the United States, which is a very expensive proposition.

The CHAIRMAN. Very well, sir. We thank you very much.

Are there any questions?

Senator TAFT. Mr. McGovern, in reference to the deduction of foreign income taxes, do most of the Latin-American countries have no personal income taxes?

Mr. McGOVERN. Well, I do not know. There are 21 countries and they change their laws very rapidly. In Cuba our income tax on earned income, which is now in the nature of a withholding tax, was installed on January 1 of this year.

Senator TAFT. What is it?

Mr. McGOVERN. It starts at 1 percent and goes to 9 percent. I cannot give you the detailed figures. It is involved, like all of these things.

Senator TAFT. Your point is even if you do not pay foreign income taxes but can be credited on the American tax, there are other taxes, indirect taxes, that you do have to pay in one way or another.

Mr. McGOVERN. Yes, sir. We pay a tax of 17 cents a gallon on gasoline. On an automobile which comes in there the duties and sales taxes amount to 33 percent; on radio, 75 percent—on the New York cost basis I am speaking of—and on a refrigerator they are 41 percent.

And it is similar on many other things. These are regular prices here, they are not wartime prices that I am speaking of, and these are normal taxes which we pay on American products of that kind.

Senator DAVIS. Mr. McGovern, how many citizens of the United States are in Latin America?

Mr. McGOVERN. According to the best estimate I could get, it was about 56,000 men, women, and children.

Senator CONNALLY. Let me ask you a question: Suppose an American residing in Mexico was in the employ of an oil company, we will say—I do not suppose there are any now, but there were—a branch of a subsidiary which incorporated in Mexico, would you, under this provision, exclude all the salary that he would draw from that oil company?

Mr. McGOVERN. If he was a resident in Mexico, raising his family in Mexico, maintaining his house in Mexico——

Senator CONNALLY. The bill has nothing to do with that. There is nothing in the bill about raising a family. Just leave the family out.

He is residing in Mexico, getting $10,000 a year from the Husteca Oil Co.; under this amendment he would not pay any United States taxes?

Mr. McGOVERN. I believe not.

Senator CONNALLY. Well, you say you believe not. You drew it and submitted it. I would like to know.

Mr. McGOVERN. It is our intention to exclude all definite residents abroad, to ask for their exclusion.

Senator CONNALLY. That is all.

Senator TAFT. What is your status on other income? Do you pay a personal income tax on other income derived in the United States,

or do you pay the same that an alien would pay, an Englishman residing in the United States?

Mr. McGOVERN. No; we make an American income-tax return on all of our income earned in the United States, and we have to include any unearned income which we may receive from foreign countries.

Senator TAFT. From foreign countries?

Mr. McGOVERN. Yes; if it is unearned income.

Senator TAFT. You just take out of that your salary? That is permitted to be deducted?

Mr. McGOVERN. Yes.

Senator GUFFEY. Mr. McGovern, one question. You say the personnel of the American in foreign trade has improved and is now very good. Is that correct all through South America?

Mr. McGOVERN. That is correct all over the world, insofar as my experience goes, especially in South America because in 1926 young men with college training, engineers, professional men, dentists, lawyers, accountants, have taken up foreign work.

Senator GUFFEY. I agree with you that prior to that time there was a lot of room for improvement.

Mr. McGOVERN. I think so.

The CHAIRMAN. All right.

Mr. Nave, of the American Chamber of Commerce of Rio de Janeiro.

STATEMENT OF CYRIL W. NAVE, RIO DE JANEIRO, BRAZIL, REPRESENTING THE AMERICAN CHAMBER OF COMMERCE FOR BRAZIL

Mr. NAVE. Mr. Chairman and gentlemen, I am Cyril W. Nave, an American citizen and resident in Rio de Janeiro. I did not come here purposely to present this report, rather I was here on urgent business and was asked by my chamber of commerce to make this presentation, which I am very happy to do.

In view of the statement which the chairman has just made, I shall not read this statement. However, if the Chair would permit, I would like to draw from my personal experience to emphasize the underlying thought in my memorandum.

The CHAIRMAN. You may do so.

Mr. NAVE. I went to Brazil in 1921. I have been there 21 years.

During my first 5 years in Brazil I traveled from the south—from the cattle country in the south—to the Amazon River in the north. I think I was in every accessible port in the country. I visited most of the important hinterland cities. During those 5 years, after having left the cities of Rio and Sao Paulo, I very seldom met any of my fellow countrymen.

Nevertheless, in almost every other port I would meet the Britisher with his insurance agency, his shipping agency, maybe his general merchandise, his club, and perhaps his school.

I would meet the German with his shipping organization, his drug business, his hardware business. Similarly, the Italians and, to some extent, the French. Back in those days our American firms were largely staffed by nationals of Europe or of Great Britain.

Since 1926 we have seen a very satisfying change. There has been a steady influx of intelligent, vigorous young Americans. Today, when

I make those same trips I will find Americans in Porto Alegre on the south, and I will find them in Belem in the north, bringing out the nut and oil; you will find them on the Amazon River. I think nothing should be done which will tend to discourage the young man coming abroad, where he will be outnumbered by the British, by the Germans, by the nationals of every other important trading mission. We simply urge that nothing be done which will tend to discourage the younger men from carrying on the fight which they have very successfully waged during the last 15 years.

The CHAIRMAN. Any questions, gentlemen?

Senator TAFT. If this is amended by saying "bona fide residence," what makes a man a resident? How long should he stay there to be exempt?

Mr. NAVE. Personally, I think he should reside there at least 1 year.

Senator TAFT. I suppose a good many of those men come back to the United States; they go back and forth.

Mr. NAVE. Yes; perhaps after a tour of duty of some 3 years, maybe 4 years. In my first instance, I was almost 5 years away.

Senator CONNALLY. Are you in an individual business, or do you work for a company?

Mr. NAVE. I work for a corporation in the distribution of kerosene and gasoline.

Senator CONNALLY. What oil company?

Mr. NAVE. The Atlantic Refining Co., Philadelphia, Pa.

The CHAIRMAN. The present law is that a continuous residence of 6 months in a foreign country entitles one to this credit on earned income.

Mr. NAVE. That is right. I think that is insufficient.

The CHAIRMAN. But it must be a bona fide actual residence abroad in a foreign country. You have no objection to that, of course.

Mr. NAVE. Mr. Chairman, I am not sure I understand the last part of your question.

The CHAIRMAN. I say the whole thing turns upon the bona fides of the residence abroad.

Mr. NAVE. That is right.

The CHAIRMAN. You have no objection to that?

Mr. NAVE. None whatever.

The CHAIRMAN. Men who are out of the country temporarily, even for 6 months, where it is a temporary residence where they do not propose to make it permanent, they stand on a different basis, I guess.

Mr. NAVE. I think they should. I think they jeopardize the right of the young men who go abroad to make their future abroad.

The CHAIRMAN. I agree with you. All right, thank you.

(Mr. Nave submitted the following memorandum:)

MEMORANDUM PRESENTED BY C. W. NAVE, OF RIO DE JANEIRO, ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE FOR BRAZIL

1. We sincerely believe that abolition of the present exemption would put a premium on foreign managers and employees of American branch houses and other American business activities in foreign countries to the detriment of American interests.

2. Some Americans resident in Brazil are employed by Brazilian organizations and the same argument would apply in their cases, and taxing the Brazilian earnings of these Americans would tend to result in their positions being taken

by nationals of other countries, whose governments do not assess income tax on their nationals residing and earning their livelihood abroad.

3. American firms with substantial American personnel abroad will be placed at a severe financial disadvantage as compared to competing firms of foreign nationalities.

4. There are various local taxes which are not in the nature of an income tax and therefore would not be deductible from the United States tax if imposed. One of our American members, who is engaged in business in his individual name and represents a number of American manufacturers has submitted to us a statement showing that in 1941 he was required to pay a municipal business tax, Federal district industries and professional tax, a special tax because he deals with electrical materials, industrial and professional taxes in the State of Sao Paulo, a special publicity license tax in Sao Paulo, internal revenue taxes in Porto Alegre and Recife, a tax on his business signs, as well as a number of other miscellaneous taxes which amounted to nearly $1,000 in 1941. These do not include a 1¼ percent sales tax nor a 4 percent social security tax on all salaries, nor double Brazilian income tax as a merchant and as an individual, respectively. Add to all this the proposed heavy United States income tax and it is doubtful if he will be able to remain in business. The above do not include the documentary stamp tax on all transactions nor the syndicate tax. Certainly anyone of another nationality will be in a far better position to replace him from a tax viewpoint.

5. Americans resident abroad reap little or no benefit from the taxation imposed upon them in Brazil. The Rio colony is typical of those of most communities, who, in addition to meeting the various taxes imposed by the Brazilian Government, must maintain their own schools and hospital facilities if their children are to be instructed in the English tongue and according to American standards.

During the last few years a relatively small American colony in Rio completely financed the erection of the local grade and high-school building at a cost of some $40,000. The teaching staff is composed largely of American teachers from the United States and instruction is based entirely on American standards.

The American and British colonies jointly maintain a hospital in Rio together with an adequate medical and nursing staff in order to afford our community adequate hospitalization facilities.

The point to be stressed in this connection is that, whereas at home these items are absorbed in the State and municipal tax bills, our American colony here must pay corresponding State and municipal taxes for the benefit of the Brazilians, and in addition to said taxes they must provide additional facilities at their private expense to the end that their children may be brought up under American standards. If Uncle Sam still imposed another tax the Americans resident in Brazil will be paying the Brazilian tax share, the burden of taxation in the United States and still find that he must provide school and hospital facilities in addition thereto.

6. There is also the question of additional expenses to which Americans resident abroad are subject which does not apply to those resident in the United States. An American with a large family is compelled to save over a period of 2 to 3 years in order to make it possible for him and his family to travel to the United States and spend a few months there. In the case of a family of four children the round-trip passage amounts to over $5,000, and this, of course, does not include hotel and other expenses in the United States. Many Americans are placing their children in summer camps in the States inasmuch as they cannot afford to bring them here during their school vacations. These items of traveling expenses or summer camp expenses are items which would not appear in the budgets of these families except for the fact that they are residents abroad.

7. We have in Rio an organization known as the Instituteo Brazil-Estados Unidos, financed to a large extent by the colony, which is engaged in promoting cultural relations between the United States and Brazil.

We also have an American Society of Rio de Janeiro, entirely supported by the American colony, the principal activities of which are the support of indigent American citizens, aiding stranded Americans to arrange passage home, and in general meeting the responsibilities which our colony feels should be done by an organization of this kind.

8. There is also the problem of foreign exchange which complicates the proposed tax and which creates an additional burden. For example, if an American receives compensation in dollars his funds are converted at present at the rate of about 19$400 per dollar. If, however, he wishes to purchase dollars for purchases other than importation of merchandise he is required to

buy dollars at the rate of 20$200 per dollar plus a 5-percent remittance tax or a total difference of nearly 10 percent on such remittances. It is doubtful if such a remittance tax would be deductible under United States income tax regulations. Further, on account of the exchange restrictions which exist in Brazil, there is no precedent to know whether it would be possible to buy American dollars for tax purposes.

9. The most important reason why our Government should not impose income tax on bona fide nonresident nationals can be based on evidence brought out in the following concrete example.

Our chief public utility organization in Brazil is Canadian. Its key positions are filled by Canadians, Englishmen, and Americans, and at present the management contemplates the addition of three engineers on their staff. If American engineers are faced with paying United States income tax, is it not obvious that these posts will go to the nationals of Canada, England, or some other country? In brief, no country to our knowledge imposes an income tax on the income of these nonresident nationals earned abroad. If the United States really desires to encourage better relations with Latin-American countries it can hardly accomplish that aim by burdening American citizens there employed with a tax which the nationals of other countries need not pay. Should Uncle Sam be the first to take the prejudicial stand tending to curtail further infiltration of Americans in these countries or prejudice the interests of those already there?

10. If this exemption is eliminated American organizations abroad employing Americans, Brazilians, and other nationals will be faced with a complete disruption of present salary schedules, built up over a period of years on the basis of capabilities, length of service, etc., in that Americans will suffer a substantial cut in their income whereas other nationals will not be affected; this will result in discrimination against Americans, who will receive considerably less net income than their associates.

11. Americans here are quite in agreement with the amending of section 116 (a) so as to exempt only bona fide nonresidents. We are aware that some Americans have abused the 6 months and a day provision of the present law. Recently an American executive stated that by prolonging his sojourn a few more weeks than was necessary he would avoid payment of income tax well in excess of the total salary of many bona fide nonresident Americans in our colony. Our frank opinion is that the Federal Treasury can receive a great deal more by way of income tax from this group of Americans than by imposing the tax upon bona fide nonresident Americans.

The CHAIRMAN. Mr. McGrath of the American Chamber of Commerce, of Argentina.

STATEMENT OF JAMES E. McGRATH, BUENOS AIRES, ARGENTINA, REPRESENTING THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN THE ARGENTINE REPUBLIC

Mr. MCGRATH. Mr. Chairman and gentlemen of the committee, like my predecessors I was very much encouraged to hear the chairman's opening remarks.

My name is James E. McGrath. I am an American citizen born in Boston. In the last 32 years I have spent about 23 in Latin America—8 years in the Canal Zone under the United States Government and practically 21 years in Argentina. I have also traveled in some of the other Latin American countries.

For more than 20 years I have been employed by an American branch bank in Buenos Aires. My work includes the editing of a monthly bulletin on economic conditions, placing American exporters in touch with Argentine importers, and vice versa, and market analyses of various kinds.

My feeling is that the principal value each one of us can give to the testimony today is to bring in the local point of view, because naturally each country has its own problems.

I am married and have four children, the oldest of whom is now 17. I recently brought him to the States, to put him in school where he could prepare for eventual entry into an American college.

The Chamber of Commerce of the United States of America in the Argentine Republic took advantage of my being here to ask that I represent them before your committee. They have prepared a brief, of which you have copies, and which I request to have included in this hearing as an appendix to my oral testimony. To save the committee's time, I shall only read a few extracts from this brief, but I should like to comment upon some phases of it.

It is necessarily similar to other briefs submitted, because the general conclusions of American businessmen resident abroad naturally coincide. Therefore, I shall try to limit myself to the Argentine picture, with which I am familiar, after subscribing to the remarks of the speakers who preceded me.

We Americans in Argentina do not question the necessity of increased taxation by the United States Government. We merely wish to discuss the matter as it affects United States foreign trade running into annual totals of billions of dollars. We are convinced that the small total of additional revenues that might be obtained from the proposed tax, if exchange restrictions in foreign countries do not prevent us from remitting, as is sometimes the case, is entirely out of proportion to the damage which will certainly be done to our carefully built up volume of foreign trade.

We believe that the tax would be an unbearable burden for the American personnel permanently residing abroad, which can be properly trained only by years of effort and at the expense of a heavy turn-over resulting from inadaptability, sickness, or dissatisfied and homesick wives.

Such inadaptability is not readily admitted by head offices which have invested time, salaries, and traveling expenses in men who are given many chances to produce before they are earmarked as duds and sent home for any one of several reasons. In other words, the overhead is much greater in that particular phase of foreign trade than it is domestic business.

Of the five principal factors entering into foreign trade, price, credit terms, delivery date, quality, and service, Americans, in Argentina at least, emphasize quality and service and believe it is more important for head office men to start a foreign career with a thorough knowledge of the product than of the foreign language, which can be acquired later.

The corollary to this theory is that in Argentina the proportion of head office men to local employees is very low. Out of 550 employees in our own organization, we rarely have as many as 20 Americans. One very large automobile company has but one head office man among its hundreds of employees, and that is the general tendency.

Buenos Aires is probably the world's keenest battle ground for foreign trade. Argentine progress is based upon the truest kind of wealth—raw materials for foodstuffs and clothing, man's primary needs.

The great volume of such raw materials exported in normal times provides the wherewithal to purchase a wide variety of expensive imported goods, and foreign exporters dance attendance upon this market. Of the 13½ million residents of Argentina, nearly 90 per-

cent are of Spanish or Italian origin. The population is about 97 percent white, the remainder being mostly Indians. There are approximately 230,000 of Germanic origin or descent; similar numbers of Russians, Poles, and other Central European peoples.

May I mention that I am including those of European ancestry as well as those who have been born in the foreign countries. There are some 40,000 British or Anglo-Argentines, and only 4,000 Americans, including women and children.

It is not necessary to remind this committee of the many handicaps under which American businessmen in Argentina have labored in the past 20 years, including customs, sanitary, and exchange restrictions emanating from both Washington and Buenos Aires.

Nevertheless, this handful of Americans are now No. 1 boys in Argentine foreign trade.

Let me call your attention to a very few paragraphs in the chamber's brief. One reads:

> The cost of living abroad for the average businessman is almost invariably higher than that of living at home, chiefly because of the necessity of adjustment to radically different environment, because of higher cost of education—both locally and when children return to the States to school—and because of high transportation costs to and from the United States. Even if income taxes paid to foreign governments are deductible from such taxes due to the United States Government, relief afforded is relatively small, considering that a much higher proportion of total taxation, at least in Latin-America, is represented by various indirect taxes than is true in the United States.

To substantiate that statement, Mr. Chairman, I have before me the April bulletin of the Central Bank of the Argentine Republic which shows in the year 1941, which is similar, in general, to previous years, out of a total revenue of 958,446,000 pesos, that income taxes amounted to 143,236,000 pesos, or roughly 15 percent.

On the other hand, there are various other taxes. The customs duties, which are unusually low, because exchange restrictions made it very hard to import last year, were 218,607,000 pesos or 22.8 percent as against 15 percent for income taxes.

Excise taxes upon liquors of various kinds, beer, wine, tobacco, and cosmetics, and a number of other articles, all consumers' goods, amounted to 262,171,000 pesos, or 27.3 percent.

Most Latin American countries have stamp taxes, which call for stamps upon almost any sort of document, from checks to real-estate transfers. They amounted to 66,421,000 pesos, or 7 percent.

The sales tax produced 45,648,000 pesos, or 4.8 percent.

Licenses, together with inheritance taxes—they are not broken down here—produced 42,388,000 pesos, or 4.6 percent.

With the exception of the inheritance tax, all of those that I have mentioned—and I have purposely excluded the real estate tax—amount to a great deal more, as you can see, than the income tax.

The income tax in Argentina starts with 3 percent for employees and 5 percent on any kind of unearned income. There is a surtax starting at 10,000 pesos, roughly $2,300 per year, or ½ percent, which gradually increases to 7 percent at 250,000 pesos, or roughly $100,000, so that the total tax could reach 12 percent.

I would say that the majority of Americans down there pay around 5 to 6 percent; but, as I have tried to point out, that is only a small part of the total taxation.

We have mentioned automobiles. Some 13 years ago, before the world-wide debacle of 1929, when the Argentine peso was at par, which was at that time roughly 42½ cents American money, an automobile importer calculated roughly that, to make a profit, he should sell an American car for four times the amount in pesos that it cost here in dollars.

A Ford, for instance, selling at $600 in Detroit would sell for about 2,500 pesos in Argentina. Today the Argentine peso is worth slightly over 23 cents. Or, putting it in another way, $100 American money which was worth 235 pesos in 1929 today is worth 425 pesos in the free market.

So that today, with increased duties, increased freight, and adverse exchange, not to mention the fact that automobiles were very hard to get before the American restrictions were placed in effect because of the Argentine import restrictions, the automobile importer calculates that he should get 11 or 12 pesos for each $1 value of an American automobile as compared with 4 pesos some 13 years ago.

That is one of many indications of the greatly increased cost of living.

Another paragraph in the chamber's brief remarks:

> Because of this higher cost of living, and also because living abroad entails personal sacrifices of many other sorts, the American employee requests, and must receive, if he is to be retained, a higher net salary than he would be paid at home. In most countries in South America people of influence, people in the ruling class, are formed of very small groups, usually of wealthy individuals. If Americans are going to maintain effectively their positions in such groups and be of any value as salesmen and representatives of their country, they must spend greater sums of money in housing, entertaining, and the obligations of a more active and varied social life than would have been the case if they were living in the United States. It is difficult to isolate such additional costs in home entertainment and charge them to an expense account, so that such entertaining forms part of living expenses.

In Argentina, unfortunately, there is no very reliable index of the cost of living, but the Central Bank keeps very careful records of commodity prices.

Any statistician knows that there is quite a lag between the rise in wholesale prices and the rise in retail prices, but the figures which I am going to give I think will indicate to any layman that there must have been some great increase in the cost of living in Argentina in recent years.

Using 1926 as a base of 100, in March of this year the general level of wholesale commodity prices in Buenos Aires was 179, and it would have been much higher were it not for the fact that meanwhile the principal Argentine products had dropped in value to 80.1, whereas all other nonagricultural products, including mostly imported goods, had risen to 206.1.

I should like to add this personal note. Having worked in a bank in Buenos Aires for more than 20 years, I have a reasonably good idea of the financial situation of the average American abroad. He comes back from his triennial or quadrennial vacation—this is my fourth vacation in 21 years—usually broke and often in debt, ready to start again.

As his children grow up, he tries to save enough to send them up here to school, where he loses touch with them for several years, not for a few months as you do when your boys go to college, in order that,

if born abroad, they may become accustomed enough to the United States to choose American citizenship. They are usually entitled to dual citizenship under the laws of foreign countries as well as our own until they are 21 years of age. If he must pay a United States income tax, your average American abroad will either come back to the States or find himself unable to give his children an American education, meaning that the second generation which should be even more helpful in foreign trade, will become nationals of the country where they live.

Now, may I read these very few paragraphs of the chamber's brief:

The proposed annulment of the exemption "would make it even more difficult than it is now to get representative and capable Americans to go abroad, unless their firms were to make up for this taxation through salary adjustments which would automatically increase the cost of doing business and put American trade at a big disadvantage. American firms which found that they could not compete on such a basis would then be obliged to economize by hiring nationals of other countries for administrative posts and also to give representation of American lines to such nationals, reverting to the condition which existed before American business entrenched itself in foreign markets.

It goes without saying that it suits the United States Government—and especially so in times of stress—to have American businessmen available abroad to supply them with trade and other information which would not be otherwise available to Government representatives.

We feel that this is not a personal matter, nor in any way an attempt on the part of individuals to escape personally warranted taxation. The problem seems to be whether the relatively insignificant additional revenue directly resulting from this tax would not be outweighed by the great damage to American business interests, from the standpoints of the value of having American employees resident abroad and of creating an additional obstacle for American firms to meet export competition.

During the past 25 years the United States has never fallen below third place in Argentine foreign trade, has usually been in second place and, at present, is in first place. This is being accomplished by a mere 4,000 American citizens resident in Argentina, including women and children, against immeasurably larger groups of citizens of competing nations. We believe that this outstanding success should not be dangerously handicapped by eliminating the present exemption only to obtain an insignificant increase in revenue.

This refers entirely as have the remarks of the previous speakers, to bona fide residents in foreign countries.

Thank you.

The CHAIRMAN. Any questions?

Senator CONNALLY. Do you work for a subsidiary of some company here in the United States?

Mr. MCGRATH. I work for the branch of The First National Bank of Boston.

The CHAIRMAN. We thank you very much, Mr. McGrath.

(Mr. McGrath submitted the following memorandum:)

MEMORANDUM OF CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN THE ARGENTINE REPUBLIC, SUBMITTED BY JAMES E. MCGRATH

I

The Chamber of Commerce of the United States of America in the Argentine Republic is convinced that the annulment of exemption from income tax on income earned abroad for bona fide nonresident Americans would not be in the best interests of the United States.

It believes that the basic and strongest argument against this new taxation is the adverse effect which it would have upon American foreign trade although it recognizes that the effect upon the individual should also be borne in mind, since that in turn would have a very serious influence upon his willingness to live abroad in the promotion of trade.

The development of American business abroad owes much to specially trained American personnel, particularly so where quality rather than price has been the selling factor. Nonresident citizens of competing countries are not subject to income tax in their home countries (some of them are even subsidized in their trade). Such taxation would make it even more difficult than it is now to get representative and capable Americans to go abroad, unless their firms were to make up for this taxation through salary adjustments, which would automatically increase the cost of doing business and put American trade at a big disadvantage. American firms which found that they could not compete on such a basis would then be obliged to economize by hiring nationals of other countries for administrative posts and also to give representation of American lines to such nationals, reverting to the condition which existed before American business entrenched itself in foreign markets.

It goes without saying that it suits the United States Government—and especially so in times of stress—to have American businessmen available abroad to supply them with trade and other information which would not be otherwise available to Government representatives.

From the individual standpoint, the chief considerations seem to be the following:

1. The cost of living abroad for the average businessman is almost invariably higher than that of living at home, chiefly because of the necessity of adjustment to radically different environment, because of higher costs of education—both locally and when children return to the States to school—and because of high transportation costs to and from the United States. Even if income taxes paid to foreign governments are deductible from such taxes due to the United States Government, relief afforded is relatively small, considering that a much higher proportion of total taxation, at least in Latin America, is represented by various indirect taxes than is true in the United States.

2. Because of this higher cost of living, and also because living abroad entails personal sacrifices of many other sorts, the American employee requests, and must receive, if he is to be retained, a higher net salary than he would be paid at home.

II

Practically all Americans living abroad may be considered as ambassadors and salesmen, ambassadors for the American way of life and salesmen of American goods. They carry with them American traditions and use American conveniences as a rule. For such conveniences they must pay higher freight and duties on articles of American manufacture, and it costs them a great deal more to be good salesmen and representatives of American policies than it would cost the same individuals if they were living in the United States. As foreigners representing American business, United States citizens are virtually compelled to maintain higher living standards, and as ambassadors of the good-neighbor policy contacts with local people of influence are necessarily more costly. In most countries of South America, people of influence in the ruling class are formed of very small groups, usually of wealthy individuals. If Americans are going to maintain effectively their positions in such groups and be of any value as salesmen and representatives of their country, they must spend greater sums of money in housing, entertaining, and the obligations of a more active and varied social life than would have been the case if they were living in the United States. It is difficult to isolate such additional costs in home entertaining and charge them to an expense account, so that such entertaining forms part of living expenses.

Health conditions are generally not as good for persons living in foreign countries as they are in the States. To safeguard one's health, and for hospital and medical services, one is generally called upon to spend much larger sums than if he were living at home.

Consequently, after having to spend a greater part of his salary than would be the case if he were living in the States, a United States citizen living abroad does not have much left over.

An American living abroad is called upon to make many sacrifices. He loses contacts with friends and business acquaintances, so that when he returns it is difficult for him to renew former connections, and he is forced to get along, in great part, on what he has been able to save while in foreign service. If he is fortunate enough to continue in business abroad until he reaches retirement age, with what he has saved he is obliged to go to the expense of setting up his home in the States and usually to suffer a loss on what furnishings or housing facilities he has had in the foreign country when attempting to dispose of them.

III

We feel that this is not a personal matter, nor in any way an attempt on the part of individuals to escape personally warranted taxation. The problem seems to be whether the relatively insignificant additional revenue directly resulting from this tax would not be outweighed by the great damage to American business interests, from the standpoints of the value of having American employees resident abroad and of creating an additional obstacle for American firms to meet export competition.

Annuling the exemption would have one of two effects. Either the companies able to afford it would bear the additional expense through augmented salaries, or much of the American personnel would prefer to return to the United States if this tax were applied and salary adjustments were not made. If salaries had to be augmented, the question would then probably be whether the size of the American staff should not be reduced as it would be much cheaper to employ additional local help rather than to pay the usual higher American personnel salary, plus additional United States income taxes. During the past 25 years the United States has never fallen below third place in Argentine foreign trade, has usually been in second place and at present is in first place. This is being accomplished by a mere 4,000 American citizens resident in Argentina, including women and children, against immeasurably larger groups of citizens of competing nations. We believe that this outstanding success should not be dangerously handicapped by eliminating the present exemption only to obtain an insignificant increase in revenue.

The CHAIRMAN. Mr. Sollenberger.

STATEMENT OF W. S. SOLLENBERGER, REPRESENTING THE AMERICAN CHAMBER OF COMMERCE OF MEXICO

Mr. SOLLENBERGER. Mr. Chairman, and gentlemen of the committee, my name is Walter S. Sollenberger. I have been employed by American interests in Mexico for the past 20 years. I have been a resident there during that time.

On behalf of the American Chamber of Commerce of Mexico, I have filed with the clerk the memorandum which was prepared by the American Chamber of Commerce of Mexico. I shall not read it.

Senator GUFFEY. Will you speak a little louder, please.

The CHAIRMAN. Yes; speak loud enough so all of these gentlemen can hear you.

Senator GUFFEY. It seems that the American Chamber of Commerce men in Latin-American companies have lost their voice.

Mr. SOLLENBERGER. I am not going to read this memorandum. I have presented it.

I am going to make a few remarks in connection with the subject, possibly in amplification, to a slight extent of the memorandum.

The American Chamber of Commerce of Mexico feels that the most vital point involved in this proposed change in legislation is the possible effect on the implementing of the foreign-trade policy of the United States.

The United States Government is now committed to a policy of trade expansion. That is best implemented and put into effect by the men in the field.

We feel that in Mexico American business has a rather high-class representation, and they have been, we feel, greatly helpful to your accredited diplomatic representatives in Mexico, and we feel that nothing should be done in the way of removing the tax exemption from bona fide American residents of Mexico which would possibly decrease the flow of representatives of American interests there.

Senator BROWN. Mr. Sollenberger, may I interrupt you?

Mr. SOLLENBERGER. Yes, sir.

Senator BROWN. You apparently are the last witness on this subject.

Mr. SOLLENBERGER. Yes, sir.

Senator BROWN. It would certainly clear my mind if you would tell me what your present exemptions are, and what the Treasury proposes in the bill? What changes it proposes to make.

Mr. SOLLENBERGER. The exemption under section 116 (a) at present exempts all income earned by American residents abroad. It does not exempt income derived from sources within the United States.

Senator BROWN. That is substantially the same as the amendment proposed by your association?

Mr. SOLLENBERGER. Yes, sir. At the present time the wording is not "Americans residing abroad"; it is "American nonresident in the United States with a 6-month residence outside of the United States" as the governing factor for the exemption.

Senator BROWN. What do you propose to do?

Mr. SOLLENBERGER. Beg pardon?

Senator BROWN. What is it proposed to do in the bill?

Mr. SOLLENBERGER. To change it to "bona fide residence abroad," changing it from the "nonresident in the United States" to the actual residents abroad, proven to the satisfaction of the tax authorities of the United States.

My predecessors here before you have stressed the fact that there is generally some higher compensation or remuneration abroad to representatives of American firms than for like work in the United States, but they are entirely correct, insofar as Mexico is concerned in saying there are taxes, other than income tax. We have an income tax in Mexico that graduates from 1.3 to 7.6 percent. The average probably is between 4 and 5 percent for the average American resident there.

In addition to the other taxes, indirect taxes which are just as numerous in Mexico as they are in Brazil or Cuba, or in the Argentine, there should also be taken into account the high cost of living abroad; the fact that the American businessman abroad is in effect, an unofficial representative of the United States before the people of the country in which he is a guest, and consequently as such must maintain, if he is going to be able to fill his position properly and properly represent his interest, a considerably higher standard of living than would be necessary than if he were working here.

The legislation that was passed in 1926 has been very helpful in increasing the representation abroad. We feel at this time, when

the question is not to sell goods but to get goods to sell, and when practically every business in Latin America, American business in Latin America is faced, if not with cessation of profit for the war period, possibly even with the certainty of a direct loss, and during which time the American firms having representation there are planning, from the far-sighted standpoint, on continuing their representation, that no legislation withdrawing this portion of the privilege which Americans abroad enjoy should be enacted at this time.

That, I think, is about all I have to say, sir.

The CHAIRMAN. Thank you very much.

Senator CONNALLY. May I ask you a question?

Mr. SOLLENBERGER. Yes.

Senator CONNALLY. What company are you employed by?

Mr. SOLLENBERGER. The Husteca Petroleum Co.

Senator CONNALLY. Are they still doing business there?

Mr. SOLLENBERGER. They still have an office there.

Senator CONNALLY. But not doing business?

Mr. SOLLENBERGER. No.

Senator CONNALLY. You are still on the pay roll?

Mr. SOLLENBERGER. I am still on the pay roll.

Senator GUFFEY. You still hope to be back in business?

Mr. SOLLENBERGER. We still hope we may.

The CHAIRMAN. Thank you, Mr. Sollenberger.

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

MEMORANDUM BY W. S. SOLLENBERGER ON BEHALF OF THE AMERICAN CHAMBER OF COMMERCE OF MEXICO

Re proposed deletion of section 22, paragraph (b) 8 and section 116 (a) of the Internal Revenue Code of the United States of that part providing for exclusion from gross income of "Earned income from sources without the United States."

GENERAL

It is the considered opinion of this chamber that the above proposed action would be a great mistake since the reasons which prompted the original inclusion of this clause in the act still prevail.

NECESSITY OF HIGHEST TYPE OF REPRESENTATION ABROAD

This chamber feels that it is essential that the United States maintain in the foreign field the highest type of individual in commerce, industry, and the professions, as these representatives symbolize to a large extent, to the people of the countries in which they reside, the people of our Nation and upon them depends to a considerable degree the success of our foreign trade. Should the clause which forms the subject of this memorandum be abolished at this time, it is felt that the firms employing these representatives would not find themselves in a financial position, because of decreased foreign business due to war conditions, to increase the compensation of these representatives in an amount sufficient to offset that portion of the additional tax necessary to insure the continued employment in the foreign field of the type of representatives that are most desirable. The United States Government is committed to a policy of doing its utmost to increase our trade with other nations and to furtherance of the good-neighbor policy through forging closer commercial and industrial relations. The proper type of American representation abroad is one of the most potent factors in implementing that policy.

LIFE IN THE FOREIGN FIELD

American citizens resident abroad forego many benefits, privileges, and civil rights enjoyed by taxpayers resident in the United States. Among these may be mentioned the facilities afforded by our museums, libraries, national parks, etc. These nonresidents are subjected particularly in parts of the world where less progress has been made, to many risks to health and life not experienced by citizens residing within the United States. The risks of contracting diseases, particularly tropical, to which our nationals are especially susceptible, indigenous to certain countries, are great and the prevention and treatment of these diseases are expensive.

EXTRAORDINARY EXPENSE OF LIFE IN THE FOREIGN SERVICE

(a) *Education of children.*—It is a patriotic duty of Americans resident abroad, if financially able to do so, to send their children during their formative years for schooling in the United States. This is a legal obligation, if the children are not to lose their rights to citizenship, in the case of progeny having either a foreign father or mother (ch. II, sec. 201, Nationality Act of 1940). This schooling involves a material and extraordinary outlay on the part of the parents, for tuition, living expenses, and traveling expenses of the children to the United States and return. Even though the nonresident American children are not sent back to the United States for all or part of their education, an extraordinary expense is incurred for tuition for these children, when they attend schools in the foreign countries whereas if resident in the United States, the facilities of the public grammar and high schools as well as the State universities are available without this expense.

(b) *Medical attention.*—Sanitary conditions in many countries are far below the standards of the United States and such diseases, relatively unimportant at home, as malaria, typhus, and typhoid are prevalent in many places. The average American resident abroad is very susceptible to these diseases as he does not have the same immunity enjoyed by the natives of those countries where these diseases have been prevalent for many generations. These hazards not only involve risks of serious and permanent loss of health and possible death, but also unusual expense for medical attention.

(c) *Home contacts.*—If Americans resident abroad are to maintain their American ideals and in fact remain Americans in the broad sense of the word, it is necessary that they and their children have at least periodic contacts with people and institutions within the United States. This involves extraordinary expense of traveling and living while away from their provisional homes.

(d) *Living standards.*—American residents abroad, to a certain extent, are obliged to maintain living standards approaching those prevailing in the United States. These living standards should be commensurate with those of representatives of normally competing nations such as Germany, Japan, Italy, France, and Great Britain, whose nationals are not required to pay income taxes to their respective governments. The maintenance of such living standards involves considerable more expense in the foreign field than at home.

CONCLUSION

We are proud to be in a position to state that Americans residing in Mexico are highly patriotic and are heartily supporting the policies of the Government of the United States and its war effort. They are contributing, in many self-sacrificing ways, to the war effort, among which may be mentioned Red Cross work, assistance to the accredited representatives of their Government in Mexico, and the purchase of war bonds. It is hoped that it will be understood that this plea for careful consideration of this matter will not be considered as based on selfish interests as it is our considered opinion that the part of the Internal Revenue Code to which this memorandum refers should be retained in the best long-range interests of our country.

It is further felt, if this is not done, that the high type of representation which our country does now and should enjoy abroad will be impaired to the detriment of our future prestige.

There are approximately 1,000 resident heads of American families in Mexico and it is doubtful if the increased net revenue from the relatively small number estimated to be less than 1,000, who would be liable to tax would be worth while considering the disadvantages mentioned above.

WASHINGTON, D. C., *August 4, 1942.*

The CHAIRMAN. A telegram from Mr. Harry Wright to me will be inserted in the record at this point.

(The telegram referred to is as follows:)

MEXICO CITY, MEXICO,
July 21, 1942.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C.

Am informed proposed income tax law will tax earned income on Americans' earning salaries in foreign countries not included in previous law and no other nation on earth taxes this item. Will be very injurious to American trade and representation abroad because competitors can do business cheaper without this overhead; we are told that some governments even subsidize their foreign commercial representatives. We will have a poorer type of representative of American firms as cost of living here far in excess of there. For instance, I just paid 11 cents American money for a San Antonio Express which cost a nickel there; Crisco costs 26; bacon, 56; ham, 90 cents; dried fruit, 32 cents per pound; Del Monte peaches, 90 cents can. Americans living here have no public schools. A man with five children would have to pay at least $45 a month for schools; 50 percent more for hospitals.

He is away from family and loved ones for years at the time. He pays full Mexican taxes. He loses touch and connections with things there. A man on $100 to $200 per month salary would have half the expense living there. We bring down young American experts in various lines because they do not have to pay this tax. We cannot increase their pay sufficient and compete with competitors who don't pay this tax and employ large number of European refugees. Our company will buy from American firms this year more than $1,500,000, consisting in principle of welding material, copper, iron electrodes, fire brick, alloys, machinery, and miscellaneous supplies. I am no tax dodger nor do I appeal for any tax dodger. I have paid my taxes annually in large sums for me. Estimate I will pay this year at over $200,000 and that associates in our company will increase this to $600,000, all earnings made in Mexico.

Our plants have more than $1,500,000 of machinery installed, 98 percent purchased in United States. Have lived at 47 Londres Street since November 28, 1922, with no house in the States. I have lived in Mexico 42 years and at times not visiting there for period of over 2 years. I have given over 20 years to golf and country clubs which has done much to help relations and get our Mexican friends to know us better. I help in all American charities and celebrations here and contribute liberally. All I get out of this is the pride I have in being an American.

Former Ambassador Josephus Daniels will confirm that there are a fine lot of Americans here to do their part always and who are not tax dodgers. Think present Ambassador will confirm but has been here too short time to know us as intimately. I will retire from business August 1, so this only affects my salary for 7 months. I am interested in your Americans here, American commerce, and proper American representations in all foreign countries.

Please give this careful consideration. I take liberty of appealing because have been a resident of Macon, Ga., and all that State; have come to Mexico more than 40 years ago and your well-known interests in American foreign commerce.

HARRY WRIGHT.

The CHAIRMAN. We have some communications from Nelson A. Rockefeller, Coordinator of the Inter-American Affairs, and others, which will be filed with the committee.

Mr. McClintock.

STATEMENT OF E. I. McCLINTOCK, PRESIDENT OF THE SYDNEY ROSS CO., AND STERLING PRODUCTS INTERNATIONAL, INC.

The CHAIRMAN. You wish to speak about section 116 (a)?

Mr. McCLINTOCK. Yes, sir.

My name is E. I. McClintock. I am president of the Sydney Ross Co. and Sterling Products International, Inc., which companies are engaged exclusively in the export business.

We have a business in Latin America in volume between seven and eight million dollars a year. We have 92 Americans in the field and employ a total number in Latin America of approximately 2,500 people.

Section 134 of the H. R. 7378 as passed by the House of Representatives eliminates subsection (a) of section 116, relating to earned income from sources without the United States.

The exemption was inserted in the Revenue Act of 1926 for the express purpose of encouraging foreign trade. The United States has not been an aggressive export country. Our economy had been geared to domestic markets. The export field had been looked upon as a mere dumping ground for surplus production by most American industries. The former great export countries have been shut out of the markets which are still open to United States exporters.

In spite of the serious difficulties of supplies and shipping, the United States is fast becoming export conscious, a fact that will have far reaching influence on our post-war economy. It is evident that our Government is anxious to do everything to develop and expand foreign markets.

In order to create and develop markets in foreign countries, it is necessary to send out the pick of a company's personnel. There are needed aggressive men of rounded experience, men of tact and personality, men whose judgment can be relied on to handle problems that arise day by day thousands of miles distant from the home office. Naturally, men of this type are scarce and they demand correspondingly high compensation. The physical comforts and climatic conditions in most foreign countries are certainly not what they are here. A man and his family do not have the comforts and advantages that residents in the United States enjoy. Educational and cultural facilities are by no means equal to the United States so that children must be sent to the United States to complete their education in high schools or colleges. It is necessary for a successful export man to maintain a high standard of living in order to command the necessary respect.

He must belong to clubs, entertain on a larger scale than would be necessary here, make contributions to various local charities, all of this in order to maintain the necessary prestige. The higher compensation paid does not by any means take care of the proportionately higher personal expense demanded by these needs for maintaining "face"; nor are these personal expenses chargeable as business expenses, or deductible from income. While it is true even normally that living expenses consume a proportionately greater

share of the income of men living abroad, a universal increase in cost of living makes it even more true now—with every allowance for the higher salaries paid to foreign personnel by American export companies.

If the elimination of the tax exemption becomes law, it will result in many of the key men deserting foreign fields and returning to the United States.

Senator CONNALLY. Would not you just raise their salary? You are living here; you run the business; you get the profits—would not you raise their salaries?

Mr. MCCLINTOCK. Senator Connally, at this rate, in the present year, it would be very difficult, with the fiscal year ending in an earlier period.

Senator CONNALLY. I understand if the Treasury part of the House bill does go into effect you will next year raise their salaries for them?

Mr. MCCLINTOCK. Next year we will raise their salaries, but that will not take care of this year.

Senator CONNALLY. I understand that. It will take care of them next year with increases in salaries?

Mr. MCCLINTOCK. Yes, sir; the companies engaged in foreign trade cannot make up by additional compensation for the tax that would be payable. It takes many years and large expenditures to create a market abroad. The margin of profit in export—because of higher expenses all along the line and the low purchasing power (making high prices impossible)—is lower than in domestic business. Now expenses of doing business have increased tremendously without a compensating rise in sales prices. For instance, insurance on shipments to South America runs as high as 20 percent of the value, as against a normal rate of three-fourth percent. The general result would be that foreign personnel would be lost and many companies would be forced to curtail, if not shut down completely, their business abroad.

It must be remembered that this exemption refers only to income actually earned abroad. In effect, this exemption is a subsidy to export trade. The loss in revenue in continuing the exemption would be extremely small in relation to the benefits that are obtained by the United States from the development of the export market, particularly at this time when the absence of Axis competition gives an exceptional opportunity to American industry. Other nations who have controlled export markets in the past give this tax exemption to their nationals abroad and, furthermore, have subsidized this trade in several other ways. With the exception of this individual exemption from taxation, the United States has given no material assistance whatsoever to the development of foreign markets. It would certainly be unwise to withdraw this support now.

The CHAIRMAN. We thank you, sir.

Mr. Richardson?

(Discussion off the record.)

STATEMENT OF GEORGE F. RICHARDSON, NEW YORK, N. Y., REPRESENTING STARR GROUP OF COMPANIES

The CHAIRMAN. Will you make your statement, Mr. Richardson?

Mr. RICHARDSON. Mr. Chairman and members of the committee, my name is George F. Richardson. I reside in New York City. I came to this country from Shanghai less than 2 years ago where I had been residing for about 14 years with my wife and son.

I feel a little bit alone because I am only representing small business here today. Our organizations, although incorporated under American charters, were incorporated and started abroad and not in the United States. I have no prepared statement to submit but I shall, a little later, submit a chart which I trust will graphically depict some of the points that have already been made, and which I wish to confirm.

I feel in a way that it would help if I could outline the kind of a situation which prevails, which has not so far been covered and which will not be covered by the proposed amendment thus far suggested to replace section 134.

I understand, from statements made on behalf of the Treasury, that it is felt that some tax dodgers have been hiding behind the skirts of bona fide nonresidents. The act says "bona fide nonresidents" and it is only a matter of enforcing the act in order to catch any such people. It is possible that some may have merely gone abroad for the purpose of working on a special Government contract, or something of that sort, and if they have gone for a specific purpose like that, even should they he absent for one, two, or three years, it does not constitute an abdication of their residence in the United States, and therefore the present law is quite adequate to cover them and it is not necessary, it seems to me, to attempt to kill off American trade in order to catch the few that might be caught in the same way that any other tax dodger could be caught by enforcing the law as it now stands.

In order to make clear the distinction between my position and those who have gone before, whose remarks I heartily endorse, I would like to state how the businesses I represent grew up, and to state that they are not the only businesses that have grown up under American corporate charters on foreign soil.

I went out to China in the latter part of 1926. I met there Mr. C. V. Starr, and I found that he had come to China in the latter part of 1919. He was then a single man of 27 years of age. He had just been honorably discharged from the Army after the last war and had gone to the Orient to seek his fortune, because he did not have any.

He first stopped in Japan and worked as a stenographer for some firm there, I think an American company. After about 6 months, he went to Shanghai and landed there with 300 yen in his pocket. He wanted to be a lawyer. He had studied for the bar in California and had passed the examination, been admitted, but, unfortunately, his eyesight did not permit him to do sufficient reading.

He had had a little experience as an insurance agent, and when he got to Shanghai it looked to him as if there was an opportunity for an American insurance business to enter China.

The financial stability of the American insurance business was something to tie to in a land which was as full of revolutions as China as at that time, and he started an insurance agency on the corner of Nanking and Szechuan Roads in Shanghai in one little room on the second floor.

That was in December 1919. Gradually the company extended, until it had offices in Canton, Hong Kong, Tientsin, and various other parts of China. It then overflowed into the Philippine Islands and into French Indochina, then into the Straits Settlements, then into the Dutch East Indies and Siam.

In the meantime a fleet of American insurance companies had entrusted their oriental agencies to this group, and it seemed advisable that an accounting office should be established in New York City on behalf of our companies where the head offices of the companies who were our principals and who were not controlled by us in any way, could have a centralization of their accounts.

This was done by the establishment of a New York office under a New York charter, which does no business in the United States.

However, after one of our men from Shanghai had come back here to look after this office for a period of time, he felt there were opportunities in Latin America. He went to Habana and established an office there. Subsequently, we have agencies or businesses in various parts of Latin America, including Columbia, Venezuela, Argentina, and various other places in South America and the Caribbean region.

It was very fortunate that this happened, because the war came along and our head office in Shanghai was, perforce, closed down by the Japanese occupation, as were our offices in Hong Kong, Manila, and other places there.

Some of our American staff were caught there in the occupation and are there today. We hope that two of our men are now on their way home, one coming from Hong Kong and one coming from Shanghai, who is the editor of the Shanghai Evening Post and Mercury, the only American daily there. Others are there and others were here on furlough or on business at the time when the war broke out.

Their homes were in Shanghai or Manila, and now they do not know where to hang their hats. Some are in Habana, one is in London, and some really do not know where their homes are.

This is not a new situation. Our Philippine business was managed for some time by a full-time man whose home was in the Manila Hotel. He had to travel a good deal. He had to pay the Philippine income tax, resident or not; on any income that he got there.

Now, there is no reason that I can see why a bona fide nonresident should be subject, whether a citizen of the United States or anybody else, to extraterritorial taxation by the United States.

If this were a case where the competitors of the United States citizen abroad were having to pay the same tax, we would have no valid reason for objecting to this, because all we ask is equality of opportunity. We, who have lived in China under the open-door policy know that it is the settled policy of the United States Government to maintain in China an equality of opportunity for trade.

I believe that is the settled policy of the United States Government for all foreign trade. It seems difficult then to reconcile ourselves to a policy whereby the United States Government will endeavor to

handicap its representatives in foreign trade as compared with not only the citizens of the foreign countries where these United States citizens reside, but also as compared with the citizens of Great Britain, of France, or of the Axis countries and others who come in there from their own lands and are able to compete on the basis of a lower tax and consequently a higher amount of money to live on from the same salary.

I can understand how it might be that if the Government is going to send people abroad, or if corporations who have defense contracts are going to send Americans abroad on salaries and then these Americans are called upon to pay taxes, I can understand how those Americans are not in danger of losing their jobs because the Government will not discharge them in order to employ competing foreign job seekers who can work for anywhere from 1 to 2 to 3 or 4 or 5 months' salary less per year and do the same work as the United States citizens can.

Senator DANAHER. Mr. Richardson, may I interrupt you please?

Mr. RICHARDSON. Certainly.

Senator DANAHER. Are you satisfied that the law is adequate in its delineation of a test of bona fide nonresident?

Mr. RICHARDSON. Yes.

Senator DANAHER. No question of that arises at the present time?

Mr. RICHARDSON. In my opinion, none whatsoever.

Senator DANAHER. I wonder why you injected the question of a defense industry sending a representative abroad?

Mr. RICHARDSON. I thought possibly that it might be in the minds of some, from some of the questions that were asked this morning, that if the Government people abroad were going to have to pay taxes—there was no reason why the person not in the employ of the Government or a Government-controlled contractor, should not have to pay the income tax.

But they have to meet competition in which they cannot be protected by the Government in any way. I believe it was Senator Connally who asked the question of one of the preceding witnesses with respect to what his company would do if the tax was imposed. Well, he said it would be difficult to raise their salaries this year, but they could raise them next year.

Well, I worked for corporations for quite a number of years and I know they cannot afford it, they cannot afford to be philanthropical if they hope to compete in the foreign field. If they raise those salaries, they will not be able to compete and if they do not raise those salaries, what will eventually happen is that they will employ foreigners, just as was done in Shanghai when I went there. The National City Bank in Shanghai, the branch was managed by British people, not United States citizens. I was a little surprised but I was informed that that was the policy in most of their branches in China.

At that time, there was no exemption for United States citizens from income tax. That was installed in 1926. Of recent years, the managers out there have been American citizens.

Senator DANAHER. What types of insurance did you write?

Mr. RICHARDSON. All types, sir.

Senator DANAHER. Is it not in the interest of the company to make allowances by way of expenses if the cost of living increases?

Mr. RICHARDSON. The company has to compete with the other companies in the field there. Those other companies in the field have to make no such allowances. All we ask is a chance to compete with them.

The CHAIRMAN. All right, show us the map.

Mr. RICHARDSON. I would like to illustrate graphically what I mean. This is a chart which will show the difference in the income that remains to the United States nonresident after he had paid the taxes that he has to pay to the United States and the taxes that he has to pay to the foreign country, wherever he happens to be, and he has to pay those taxes whether he is a resident of that country or not.

Now, I have drawn this chart [indicating chart No. 1] on the basis of a $7,000 income. That is not very high and not very low in the scale of the House committee report. I am going to pass this around, with the chairman's permission.

The CHAIRMAN. You can just hold it up.

Mr. RICHARDSON. On the basis of $7,000 a year for a man with two dependents, he would have, therefore, not to pay as high income tax to the United States as a single man.

The red column represents what the United States citizen would have left after paying his taxes on the average to Latin-American countries.

I have taken into account the foreign tax credit. The foreign tax credit, as you gentlemen know, is limited to the foreign income-tax credit. The income tax is a newcomer in the tax field. The United States and British Empire are much further ahead in it than other countries are. As a result, you gentlemen heard the kind of taxes that had to be paid in Latin America by people who live there.

We had the same thing in China. We had to pay 40 percent on our American automobiles. We had to pay high taxes on gasoline and all that sort of thing. It does not make any difference whether you reside there or not. If you are there you pay the tax.

Take all the taxes that the Latin-American resident, who is not a United States citizen, has to pay, and deduct them from an income of $7,000. He would not have to pay the United States income tax.

Based on the 1942 proposed rate, this represents the difference [indicating]. It represents a difference of 2 months' salary; it represents a difference of 16 percent.

The foreign competitor for the American's job will have that advantage over the United States citizen abroad who is working there. Now, that is a percentage which varies.

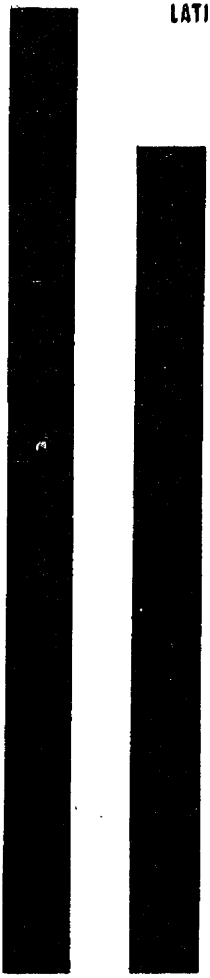
I will say at the outset that the figures on which this is based were taken partly from the 1942 House report, and partly from Tax Systems, the eighth and ninth editions, which give the collections from the various South American countries of taxes, and divides those collections into the various kinds of taxes. These charts average these countries, so that the result will not be accurate for any one country. But the result will be much greater if the accurate figures are taken.

This discrepancy, the discrimination, will be much greater if the accurate figures are taken, and I am satisfied, if the committee will call upon the Treasury Department to compile statistics for any one country, or all the countries combined, they would find the discrepancy is greater than I have depicted here.

EFFECT ON NONRESIDENTS

1942 REVENUE BILL, SEC. 134, PAGE 18

LATIN AMERICAN AVERAGE



FOREIGN COMPETITOR'S INCOME AFTER TAXES

U.S. CITIZEN'S INCOME AFTER TAXES

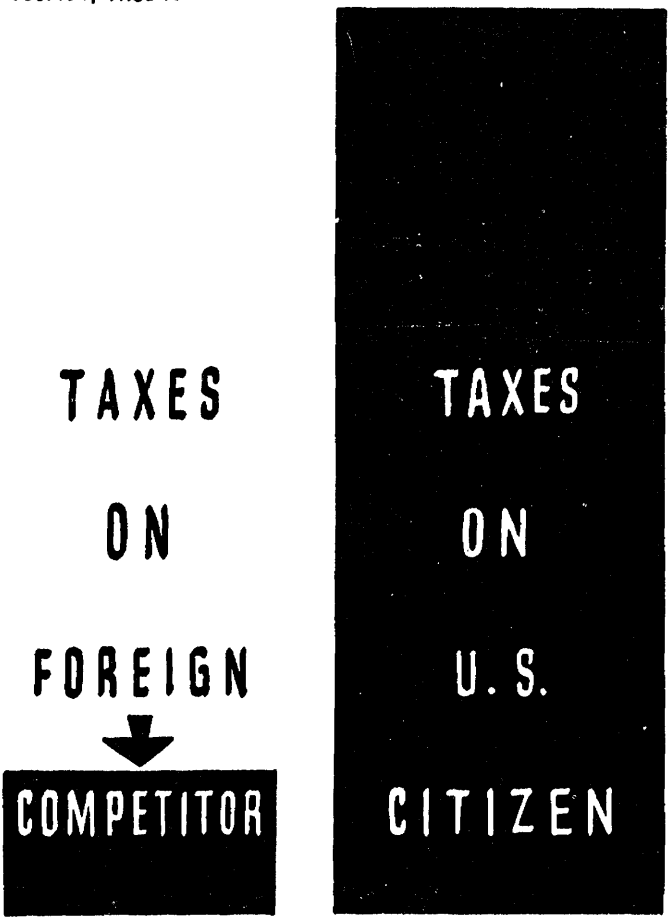
BASED ON $7000 YEARLY SALARY—MAN WITH WIFE & 2 DEPENDENTS. FOREIGN TAX CREDIT TAKEN INTO ACCOUNT AS IF FOREIGN TAXES INCREASED LIKE OURS SINCE LATEST (CHIEFLY 1940) COLLECTIONS.

CHART No. 1

EFFECT ON NONRESIDENTS

1942 REVENUE BILL
SEC. 134, PAGE 18

LATIN AMERICAN AVERAGE



BASED ON $7000 YEARLY SALARY - MAN WITH WIFE & 2 DEPENDENTS. FOREIGN TAX CREDIT TAKEN INTO ACCOUNT ON BASIS OF LATEST STATISTICS AVAILABLE (CHIEFLY 1940 COLLECTIONS)

CHART No. 2

I would like to show you the reasons for this difference. The reason for this difference is due to the difference in the tax, and here [indicating chart No. 2] is a graphic depiction of the difference in the tax which the United States citizen would have to pay as compared with the tax which his foreign competitor would have to pay.

In this connection I wish to remind the committee that taxation without representation was at one time a slogan which caused the Thirteen Colonies to expatriate themselves from England. This is not merely taxation without representation, it is not even just double taxation without representation; look at the difference in those taxes. That is on the basis of $7,000 a year, a man with two dependents, a wife and two dependents.

That is an average.

Now, if the Treasury would care to check the figures on the latest tax for any South American country, or for all the South American countries, and average them, I venture to say they will find that the discrepancy is greater than is indicated there.

That is why it is a discrimination against the United States citizen. If he works for his Government, it may be that his Government will not fail to stick by him, but if he works for private companies that have to compete in a foreign field, where there are competing companies of other nationalities which do not have to meet the extra expense of paying their employees enough to be able to pay the tax of the size proposed for 1942——

The CHAIRMAN. I think we get your point. Is there anything else you wish to submit?

Mr. RICHARDSON. I will be glad to submit the tables on which this is based, but I do not have them ready at the moment. I can submit them to the committee's clerk. Although I feel that if the Treasury Department questions them at all, all they have to do is to check the figures with probably later figures which they have themselves.

The CHAIRMAN. Yes, sir; you may be permitted, if you desire, to submit the figures. Do you have anything else?

Mr. RICHARDSON. I would like to say that in China we had extraterritoriality. The American Government and several other foreign powers had extraterritorial rights there. That means that Congress legislated for the Americans in China and we had a United States Court in China, and I practiced law there for 13 years.

Extraterritoriality probably is now a dead letter. Extraterritoriality is considered a throw-back. To the best of my knowledge, the only vestige that remains of extraterritoriality in the world today is the proposal of an extraterritorial tax on United States citizens abroad.

I realize that sometimes people living in the United States here at home think that the benefits of the United States Government are great to its citizens abroad. I think we have to compare that with the benefits received from the United States Government by its citizens at home.

Abroad we do not have the right to trial by jury; we do not have the right to vote, and when war comes we do not even have war damage insurance. The War Damage Corporation law does not cover Bill Hale's property out in Holly Heath in Shanghai at all, it does not cover Mr. Starr's home on Hungjao Road

They are both gone. We haven't got that protection at all. I do not think it covers a single stick of property in Latin America. That is only another instance. So that the American citizens abroad do not have value received for their taxes by any means.

And yet this proposed individual income tax, which is expected to raise, according to the House report, nearly eight billions, will be about one-third of all of the taxes to be levied by the Federal Government of the United States.

I should like also to submit a supplemental memorandum covering this general subject.

The CHAIRMAN. Are there any questions of Mr. Richardson? If not, thank you, Mr. Richardson, for your appearance.

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

SUPPLEMENTAL MEMORANDUM BY GEORGE F. RICHARDSON, NEW YORK, N. Y., REPRESENTING STARR GROUP OF COMPANIES ON THE REVENUE BILL OF 1942, SECTION 134, PAGE 78, TO DELETE SECTION 116 (a) FROM THE INTERNAL REVENUE CODE

EXCLUSION OF SALARIES EARNED OUTSIDE THE UNITED STATES BY NONRESIDENT UNITED STATES CITIZENS FROM FEDERAL INDIVIDUAL INCOME TAX

From past statements of Treasury Department representatives, I gather that they feel that some tax dodgers are hiding behind the skirts of bona fide nonresidents. Section 116 (a) as it now stands is adequate to collect taxes on all income from all who are not bona fide nonresidents. That section is expressly confined to "bona fide nonresidents of the United States." Mere absence from the United States for a specified period, even though running more than 6 months, or even more than a year, does not legally constitute abdication of United States residence. Where the absence from the United States is for a predetermined period with an intention to return at the end of that period, there is no such intention to abandon residence in the United States as the law requires in order to convert an individual's domestic residence to nonresidence.

Treasury practice has waived the law described in the last preceding paragraph. Treasury practice is to regard as a bona fide nonresident any individual who is outside the United States more than 6 months during any taxable year. Treasury practice does not count as part of that 6 months any absence of less than 1 month; nevertheless, Treasury practice does not adopt the tests universally followed by court decisions making the residential intent of the individual the controlling factor. This Treasury practice is a mere administrative procedure correctible by the Treasury Department itself.

I speak for businesses which are small by comparison with those represented by the witnesses preceding me this morning. Also, the companies I represent are not companies which have been built up in the United States. After I moved with my wife and son to Shanghai, I met there Mr. C. V. Starr, founder of the Starr group of companies. He had gone to the Orient in 1919 immediately following his honorable discharge from the United States Army. He was a single man, 27 years of age. After being employed for about 6 months as a stenographer in Japan, he went to Shanghai, where he landed in November 1919 with 300 yen in his pocket. He thought he saw there a field for operation of American insurance companies. He started an insurance agency in one small room at the corner of Nanking and Szechuen Roads in Shanghai in December 1919. The business grew and offices were opened in other parts of China; then in Hong Kong and Manila; then in Indo-China and the Straits Settlements, the Dutch East Indies and Siam. Meanwhile, the companies this agency represented had increased in number until there was a fleet of American insurance companies who had entrusted their representation in the Far East to this agency. These companies were the principals of the agency and were not controlled by the Starr group. The head offices of these American insurance companies were in the eastern part of the United States. It seemed advisable for Mr. Starr's agency to establish an accounting office in New York City where accounts pertaining to all of these companies might be centralized.

This accounting office was incorporated under New York law. The man sent back from Shanghai to manage it thought he saw an opportunity to extend the foreign agencies of the American insurance companies to Latin America. Thus,

offices were established in Habana and subsequently the business was extended to other Latin-American countries, including Colombia, Venezuela, and Argentina.

This business was built up by traveling. At least some of those who supervise it cannot remain in one country any great length of time. Meanwhile, the Japanese occupation of Shanghai, where the agency and its subsidiaries constituting the Starr group were situated and where their headquarters had always been, overtook some of the United States citizens managing these companies and kept them there, but missed some of the personnel who were traveling elsewhere on business or vacation and left these latter individuals with no homes and no place to hang their hats. There was nothing for them to do in the United States as this country has not been the field of operations of these companies. Some of them went to Cuba; one is in London. They are bona fide nonresidents of the United States and they are United States citizens. The Starr group places them where it can find work for them to do, but that is seldom in this country. Some may settle down in one country; some may travel in supervision of the business in several countries and may not be able to afford to establish a home in any one country.

It has been proposed this morning that section 116 (a) of the Internal Revenue Code be so amended as to substitute bona fide residence of an entire year in a foreign country in place of the present requirement, which is bona fide nonresidence here over 6 months of the taxable year. Such a substitution would leave the type of individual above described out in the cold. His work contributes as much to foreign trade as that of a United States citizen confining his residence to one foreign country. His supervision and trouble-shooting for American foreign trade in several foreign countries is certainly as valuable to the cause of American foreign trade as is the contribution made to that cause by the persons whom he supervises who usually confine their residence to one country.

The handicap to foreign trade which would result from the subjection of such nonresident United States citizens to the proposed 1942 Federal individual income tax is illustrated by two charts which I have here and hold up for your inspection.

The first chart compares the size of the income that would remain to the United States nonresident citizen after he had paid the 1942 Federal income tax rate on a salary of $7,000, and the average per family tax on others in Latin America. The salary remaining to the foreign competitor is 16 percent greater than that remaining to the United States citizen in the example here illustrated. This difference would fluctuate with incomes of differing sizes, with differing family status, and with differing Latin-American countries. The chart is based on the average American family of four and on the average tax rates of Latin-American countries. It takes into account the foreign tax credit allowed against the Federal income tax. However, that credit is limited to foreign income taxes. The income tax is a newcomer in the field of taxation and has not yet been developed in foreign countries as it has in the United States and the British Empire. In some of the Latin-American countries there is no income tax. In none of them is it comparable to the income tax levied in the United States. In none of them does it constitute anywhere near as large a proportion of the per capita tax as it does in this country. The consequence is that the foreign tax credit is negligible in its effect upon the amount American nonresidents would have to pay under the Federal income tax.

In preparing these charts I used mostly statistics of 1940 tax collections of Latin-American countries taken from the eighth and ninth editions of Tax Systems published by Commerce Clearing House, Inc. I rated up the Latin-American income taxes in the same proportion that Federal income taxes in the United States would be advanced by the 1942 revenue bill. Had it not been for that, the handicap of the United States citizen competing with foreigners abroad would be greater than that illustrated by this chart.

The Treasure Department may have later statistics on Latin-American taxes than were available to me in preparing these charts. If your committee sees fit to call upon the Treasury Department to make like comparisons on the basis of current tax rates prevailing in Latin-American countries, I am satisfied that the result will show a substantially greater discrimination against United States nonresidents competing with foreigners abroad than is shown by the charts I am presenting.

I now present the second chart which shows the cause for the first. The second chart compares the amount of taxes that would be paid by the non-

resident United States citizen under the proposed bill with the taxes that would be paid by his foreign competitor. You will note that the nonresident United States citizen has to pay over eight times the amount of taxes paid by his foreign competitor. This discrimination, too, varies according to the amount of the taxpayer's income, his family status, and the foreign country where he spends most of his time. The variation runs from 3½ to more than 12 times the amount of tax paid by the foreign competitor. The result is a variation of from 1 month's to nearly 6 months' salary by which the foreign competitor's income remaining after taxes, exceeds the United States nonresident citizen's income remaining after taxes. Here, too, I would welcome your calling upon the Treasury Department for verification of these comparisons, with full confidence that the result will disclose a greater discrimination against the United States nonresident citizen and in favor of his foreign competing job seeker than is disclosed by the charts which I have presented.

If United States corporations engaged in foreign trade raise the salaries of their staffs in foreign countries enough to make those salaries, minus taxes, equal to the salaries, minus taxes, of foreign staff members, such United States corporations will be handicapped by the fact that they themselves have to compete with foreign corporations having foreign staffs immune to United States taxation. Such foreign corporations are under no necessity of raising the salaries of their staff members to meet United States income taxes. Such foreign corporations are thus given an advantage in foreign trade over United States corporations—an advantage that increases with every step-up in the rate of income taxes in the United States.

Perhaps United States citizens abroad in the service of the United States Government or of corporations controlled by the United States Government are not similarly affected. This is a subject upon which I am not fully informed, but I can understand that it is within the power of the United States Government and its corporate subsidiaries to increase out of taxes the salaries of their foreign personnel if that should be necessary to retain United States citizens in those jobs. But private corporations are not in a position to pay increased salaries out of anything but earnings and when those earnings depend upon successful competition with foreign corporations in a field where the latter are immune to comparable taxation, the result is ultimate substitution of foreigners in place of United States citizens in positions abroad. This restricts the opportunities of our citizens who are competing with foreigners instead of with their fellow United States citizens. Such opportunities are even further restricted by the fact that nonresident United States citizens are equally handicapped in competing with foreign applicants for employment by Latin-American, British, or other foreign corporations or employers.

If United States corporations operating abroad do not increase the salaries of their staff members there enough to compensate for United States tax discriminations in favor of foreigners, then the effectiveness of the United States citizens so employed is reduced in proportion to the weight of United States taxation thus placed upon them. When that weight amounts to not merely 1, but 2, 3, and even 4 months' salaries per year less than foreigners with the same salaries enjoy—and is lopped off in one single year at one fell swoop—the effect cannot be laughed off.

That such effects would be harmful to the foreign trade of the United States is obvious. It would tend to an increasing reduction in the number of United States citizens which either United States or foreign enterprises could afford to employ abroad. It would tend to a reduction of the number of United States nonresident citizens who could afford to retain both their positions and their United States citizenship.

In China, United States citizens enjoyed extraterritorial rights. Thus Congress could and did legislate for Americans in China. Like rights were enjoyed by nationals there of Great Britain and various other leading powers. These rights were obtained for American citizens there by the United States Government in line with the American policy of equality of opportunity for trade with China. These extraterritorial rights did not, however, carry the burden of extraterritorial taxation. Had they done so, there would have been no equality of opportunity for United States citizens engaged in business in China. Thus, the giving of extraterritorial benefits and the withholding of extraterritorial burdens were both necessary to give equality of opportunity for trade with China.

Now, extraterritoriality in China is to be abolished. The doctrine of extraterritoriality is considered to be outdated and a relic of the reactionary past. When abolished by the United States, it will be abolished by all other foreign powers. Thus, equality of opportunity for foreign trade with China will not be jeopardized by the abolition of extraterritoriality there.

It does seem a strange time to embark upon a new upsurge of extraterritorial policy, an extraterritorial policy not calculated to promote United States foreign trade, but to handicap it.

Nonresident United States citizens do not receive from their Government values comparable to those received by residents of the United States. Persons outside the United States have no United States guaranty of trial by jury and no right to vote. They cannot vote in the United States because they are not resident here. They cannot vote abroad because they are not citizens there. They cannot vote anywhere and yet if they are subjected to the United States income tax they will be subjected to taxation without representation—in fact, to multiple taxation without representation.

United States residents are afforded Government insurance against war damage by the War Damage Corporation. No such insurance is available to United States citizens in Latin America. No such insurance is available to cover the large losses sustained by the Starr group of companies by Japanese occupation of large parts of China.

Nonresident United States citizens have no legal right—no enforceable right—to any protection from the United States Government outside of this country. Any protection afforded is an act of grace within the administrative discretion of the United States diplomatic or consular representative in any given foreign area. The extent of protection which he is able to afford must not derogate from the sovereignty of the foreign government situated there. Any person who has resided in a foreign country during a war well knows that the feeling of security enjoyed by the average United States citizen at home is utterly lacking. Everybody knows that the United States armed forces for which most of the 1942 income taxes will be levied are not expected to furnish, and are not furnishing, the same protection for United States citizens in foreign countries that they are furnishing for United States citizens at home.

To impose the Federal income tax upon the salaries of bona fide nonresident United States citizens would not only handicap foreign trade, but would be an injustice which no truly democratic government would inflict upon its citizens. That injustice consists, first, in burdening those citizens where it cannot burden their competitors equally and, second, in making those citizens pay for benefits they do not receive. That such injustice should be meted out to those few United States citizens who earn their livelihoods without competing with their fellow citizens at home, who earn their livelihoods by competing in the free-for-all rough-and-tumble of foreign trade abroad, is a consideration which I am satisfied will not be overlooked by the fair-mindedness of your committee.

If there is to be any amendment at all of the existing law on this subject the result should make section 116 (a) of the Internal Revenue Code read:

"In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this title:

"(a) *Earned income from sources without United States.*—In the case of an individual citizen of the United States, amounts received from sources without the United States if such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection."

The above-quoted language eliminates all test of residence, because

(1) Residence is a matter of intention and intention does not affect the amount of tax payable in foreign countries—only presence or absence does that; and

(2) Residence does not determine the contribution of services abroad to foreign trade—services rendered abroad are a truer guide on that.

The above-quoted language eliminates the discrimination against United States Government employees abroad. Even if this exempts our soldiers serving in foreign lands, it would not amount to 1 percent of the estimated 1942 individual income-tax yield. If the United States Government taxes its soldiers fighting abroad for their country, while foreign governments do not, full public realiza-

tion of that kind of a tax policy will be accompanied by drastic public criticism of it.

Mr. Swingle.

STATEMENT OF WILLIAM S. SWINGLE, VICE PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK

The CHAIRMAN. Mr. Swingle, you are appearing on section 116 (a)?

Mr. SWINGLE. Yes, sir. Mr. Chairman and gentlemen, I am William S. Swingle, vice president of the National Foreign Trade Council, Inc., and beg to submit, in behalf of members of that organization, some comments regarding the proposed repeal of section 116 (a) of the Internal Revenue Code.

The National Foreign Trade Council, Inc., is an organization whose members are concerned with the development and maintenance of American foreign trade, and are located in all sections of the country. Since the organization of the council in 1914, it has been interested in seeing that every reasonable facility is granted to provide for the extension of our foreign trade. One of the most important elements in the development and maintenance of our commercial relationship with other countries is the personnel resident therein and acting as representatives of American business in their respective places of residence. We are, therefore, particularly apprehensive about any legislation which would adversely affect the caliber of individuals in such service or impose hardships on those who for many years have been and are still in a position to carry on their service in behalf of American commerce. This is especially true today in our commercial relations with other American republics.

Our citizens residing abroad are faced with many additional problems and expenses in maintaining their position in foreign countries, and are also in direct competition with the citizens of other countries who are residing and doing business in such country.

In recognition of this the National Foreign Trade Council, in connection with the revenue bill of 1926, in the person of Mr. O. K. Davis, then secretary of the council, appeared before this committee and supported the proposal then enacted, to exempt from taxation on income earned without the United States, American citizens who were residents of foreign countries.

At that time Mr. Davis urged—

> inclusion in the forthcoming tax revision bill of a provision which will relieve American citizens resident in foreign countries and engaged there in the promoton of American foreign trade from tax upon the income which they earn in the country of residence.

The principle advocated by the representative of the National Foreign Trade Council at that time was recognized, and since that date the exemption has been maintained in all subsequent revenue legislation.

The basic reason for granting and maintaining this exemption is the fact that the citizens of other countries who reside in foreign countries, engaged in the conduct of commercial and professional business, are exempted from income tax by their home governments in respect of income earned in the other country where they reside and conduct their business.

While the United States has always been vitally interested in foreign trade, the fact remains that American citizens engaged in business abroad have been outnumbered by those of other nations of the world. The exclusion from gross income, enacted by the Revenue Act of 1926, was designed to encourage Americans to go abroad to develop and promote foreign trade, and to increase the volume of American trade abroad to a more nearly comparative level to that of other nations.

Nevertheless, while great strides have been made in promoting foreign trade, American citizens resident in foreign countries—in Latin America for example—are still far outnumbered by the representatives of other trading and industrial nations.

It should also be pointed out at this time that the Americans who serve abroad are responsible also for developing the taste for the use of American products in those countries by the example they set in the way they live. Moreover, it is a recognized fact that, as American citizens, they are of invaluable assistance to various of our Government departments and agencies as a source of authentic and valuable information on business and economic activities affecting the relations between respective countries.

It may be recalled that on previous occasions representatives of the council have appeared before this committee in support of amendments to secure the proper operation of the credit for foreign taxes, but we must point out that such credit is not sufficient relief for individuals who have to reside in foreign countries and who assume many burdens other than the income tax which alone is allowed as an offset against the American tax. In other words, without the desired exemption, a citizen of the United States who resides in a foreign country and carries on his business activities there would be placed at a disadvantage with his competitors in that country to the extent of the difference between the United States tax rates in effect, and the tax paid in his country of residence. This additional burden in itself is, in many cases, more than sufficient to offset any advantage which he might otherwise enjoy from his foreign service.

Should this additional burden of the higher American tax be imposed upon American citizens resident abroad, who also bear the burdens which residents of those countries must bear, we are apprehensive lest it should cause the replacement of American citizens by the nationals of other countries, and prevent other American citizens from entering this field. We, therefore, urge your support and consideration in maintaining the exemption from taxation of the earned income from sources without the United States, of American citizens who are bona fide residents of foreign countries. We urge this in the interest of the development and maintenance of American foreign commerce.

The CHAIRMAN. Thank you, sir. Are there any questions of Mr. Swingle?

All right, Mr. Swingle.

Senator Brown, are the two witnesses ready, whom you spoke of? They are next on the list.

Senator BROWN. Mr. Colerick and Mr. McKinney are the ones that Senator Van Nuys has introduced.

STATEMENT OF GUY COLERICK, FORT WAYNE, IND., REPRESENTING JEFFERSON NATIONAL UNDERWRITERS, INC.

Mr. COLERICK. My name is Guy Colerick, Fort Wayne, Ind. The gentleman with me is Mr. E. Kirk McKinney, of Indianapolis, Ind.

May I proceed now?

The CHAIRMAN. Yes, sir.

Are you connected with the Jefferson Life Insurance Co.?

Mr. COLERICK. Mr. McKinney is the president of the Jefferson National Underwriters, Inc. It is not life insurance; it is the Jefferson National Underwriters, Inc.

Mr. McKinney is the president, and I am the vice president and general counsel of the company.

Our company is a small company with but $20,000 capital, but it has an outstanding bonded indebtedness; that is, an indebtedness represented by securities of approximately $1,000,000.

The proceeds from the sale of that bonded indebtedness are placed in the hands of a trust company as trustee, less the original sales expense and a nominal or small company operating expense.

Senator TAFT. It is engaged in the general life-insurance business?

Mr. COLERICK. The underwriting company controls by majority or near majority, and operates by mutual officers the Jefferson National Life Insurance Co.

Senator TAFT. The Jefferson National Life Insurance Co. is a mutual company?

Mr. COLERICK. No; the officers of the underwriter company and the officers of the Jefferson National Life Insurance Co. are the same, and the underwriting company owns the controlling stock of the life-insurance company.

Senator TAFT. It is a stock company?

Mr. COLERICK. It is a stock company, a legal reserve life-insurance company and a stock company.

Senator TAFT. Who is it that has the $20,000 stock?

Mr. COLERICK. It is the underwriting company that only has a capital of $20,000, but has an outstanding indebtedness of approximately $1,000,000 represented by indebtedness in the form of securities which were sold and negotiated to the public.

Now, we have prepared a little memorandum which states the relief that we seek. We only represent this one company, not a group of companies. There are other companies, undoubtedly, that fit into our schedule, but we are here only representing the one company.

We have sought, by memorandum or a little factual statement that I wish to leave with the chairman, a proposed amendment to the reinstatement of section 15. That is in section 105 of the House bill. That reinstates the surtax provisions as to corporations, which was omitted from the Internal Revenue Code previously, and section 105 reinstates the surtax.

Now, we do not ask by this proposition, or this relef, to exclude this company from the payment of any kind of tax called for by this proposed bill, but what we are asking for is that the income on this trusteed fund from normal earnings and from surrenders by other bondholders at an annual surrender value, that the income

from discharged indebtedness should not enter into the calculation of the surtax.

Now, the present law excludes that income in the determination of the tax income under the normal tax if the company is insolvent. The present excess profits-tax sections exclude a part of that income now, but the surtax proposed will not exclude it.

Now, as to the relief, I am not sufficiently conversant with how to fix an amendment, I have had very little experience with it in Washington. I have had some in Indianapolis but not here.

We propose here for your consideration an amendment to section 15, as it will be reenacted by section 105 of this act and that is until this bonded indebtedness is paid, the income from this impounded trust fund which belongs, in fact, to the creditors, that until the bonded indebtedness is paid, or until that fund equals or exceeds the amount of the bonded indebtedness, the earnings from that fund be excluded from the surtax, somewhat like it is now from the excess-profits tax.

Now, the proposal is that section 105 (b) be amended by adding at the end of paragraph (a) the following:

* * * except in cases of corporations the capital of which is chiefly borrowed capital evidenced by securities issued by such corporations and which borrowed capital less expense of negotiating the sale of such securities and less the normal and reasonable expense of the operation of the business of such corporation, is irrevocably placed in the custody of a depository for the purpose of investment by it to create earnings to reimburse such deposited fund for such sales and business operation expense to the end that such securities can be retired in full, if such corporations were organized for the exclusive purpose of the sale, retirement, and discharge of such securities and the incorporation, operation, and management through mutual officers and directors of a life-insurance company, the earnings on such fund so deposited with such depository and the income derived from the retirement or discharge of said securities shall be excluded in computing and determining the "corporation surtax net income" hereunder, the "adjusted excess-profits net income" under subsection (b) of section 710 and the "section 102 net income" under section 102 until, and only until, all of said securities have been retired or discharged, or until the amount of such fund in the hands of such depository equals or exceeds the remaining unretired and undischarged securities.

By the proposed amendment your honorable committee will see that it is not our request that the company represented by us be relieved from the payment of any form of income tax covered by the Internal Revenue Code or by the present pending legislation amendatory thereof.

Our request is merely that certain income: to wit, the income and earnings of a fund actually belonging to security holding creditors of the company, and placed irrevocably in the hands of a depository to pay said creditors, shall not enter into the computation and determination of:

First, "Corporation surtax net income" under section 15 (a); second, "Adjusted excess-profits net income" under section 710 (b); and third, "Section 102 net income" under section 102.

And only until such security-holding creditors are fully paid or until the amount of such fund equals or exceeds the amount of unretired and undischarged securities held by creditors.

No request is made to exclude such income from the payment of "normal tax net income" under section 13.

Nor do we request that the company's general income be treated specially in any manner (excepting only the earnings on said deposited fund: (A) General interest and dividend earnings; and (B) Income from the discharge and retirement of indebtedness represented by securities).

The income from the retirement and discharge of the security indebtedness is now excluded in the computation and determination of "adjusted excess-profits net income" under section 710 (b) regardless of the solvency of the taxpayer and is likewise excluded from the computation of the normal tax net income under section 13 if the taxpayer is insolvent.

By our amendment we propose to extend the exclusion of such income from the computation of the "corporation surtax net income" under section 15 (a) and "section 102 net income" under section 102 and to include in such exclusion in each instance the earnings on the deposited fund so long as security holding creditors remain unpaid and only so long as the fund is less than sufficient to pay the securities held by the creditors.

Senator TAFT. Why does it make any difference if you have any income from the fund? Does that fund pay interest on the bonds?

Mr. COLERICK. They are non-interest-bearing bonds.

Senator TAFT. How do you sell them? You said you sell them to the public. How do you sell that kind of bond?

Mr. COLERICK. They each receive, in place of interest, 10 shares of stock in the life-insurance company. Each bondholder receives that. Each bondholder, as such stockholder when, as and if the insurance company is in operation long enough to be a paying company, will receive his proportionate share of dividends that may be declared. Just recently the company did declare a stock dividend. Now the holders of stock in the life-insurance company received a stock dividend but the money was left in the surplus account.

Senator TAFT. Is the underwriters company insolvent?

Mr. COLERICK. The underwriters company, if called upon today to pay would be insolvent, but we could have last year excluded the larger part of this income from our gross, but we did not avail ourselves, and purposely so, and paid our normal tax. This little company of only $20,000 capital paid $38,000 in income tax.

Now, if the surtax were put on us our tax would be increased.

The normal tax is fixed so as to relieve this income if the company will show that it is insolvent and if it has been so certified. In the excess-profits tax, the profits from the surrender of bonds or discharged indebtedness, that does not go into the gross income, but in the surtax provision that is to be enacted, they have no such remedial provision and the surtax just takes it all in, unless we claim the insolvency in fixing our normal tax income, which we have not done, and which we prefer not to do.

Senator TAFT. If you were a very rich and powerful corporation with this kind of fund, why should it be exempted?

Mr. COLERICK. Beg pardon?

Senator TAFT. Why should you be exempted if you were actually a solvent company with a lot of money?

Mr. COLERICK. The theory of this company, as set forth in the memorandum which we prepared, was, back in 1936 and 1937 when

it was organized, that on a 3-percent return, this fund would earn income sufficient to pay back the indebtedness.

Senator TAFT. I am not saying that. How can you say what applies to you does not apply to some wealthier company that should not be exempted from such a fund?

Mr. COLERICK. I presume you could do it by saying this relief could only be until the fund equals the amount of the bonds, or the bonds are paid, or if the company has other assets with which they can discharge it, and so forth.

It seems to me the law would still be the insolvency provision, and you already have that.

Mr. COLERICK. Well, we do not have that. The insolvency provision does not relieve us from the other earnings upon this fund other than just the income from discharged indebtedness, but the normal earnings on the income is not relieved in any place at all. That is in all the forms of calculation now.

In other words, the little relief that we ask the committee to give us some little consideration on is with the increase in the determination of income and with the increase in the tax brackets it is quite apparent that this little company will not be able to retire its bonded indebtedness. It is a relief to its creditors only insofar as they continue to be creditors that we are asking for.

We do not ask to relieve the company from all its other income; we make no suggestion of any kind or character in relation to that.

Senator TAFT. How much life insurance is there outstanding?

Mr. COLERICK. In the life-insurance company?

Senator TAFT. Yes.

Mr. COLERICK. A little over $13,000,000. We have only been writing insurance for 3 years. Our company only started in May of 1939, and we have written $13,000,000 plus in that time.

The CHAIRMAN. Have you talked with the Treasury about your particular problem?

Mr. COLERICK. No; we have not.

The Jefferson National Underwriters, Inc., was organized exclusively for the purpose of incorporating, operating, and managing a life-insurance company by a majority control, or a near majority control and through mutual officers and directors. The life-insurance company was so organized and is known as Jefferson National Life Insurance Co.

A part of the plan was that Jefferson National Underwriters, Inc., issue and sell, which it did, a 5-year payment 10-year retirement bond, not in excess of 4,300 in number, each in the principal amount of $750, and use part of the proceeds of such sale to purchase common stock of the said Jefferson National Life Insurance Co., 10 shares of which was guaranteed to be delivered by Jefferson National Underwriters, Inc., with each of the said bonds sold, either as part of the guaranteed surrender value or upon the retirement of the bond.

The balance of the proceeds from the sale of such securities, less sales expense, was paid, and is still being paid, and immediately deposited irrevocably with a depository namely, the Security Trust Co. of Indianapolis, Ind., to the end that the same will be invested by such depository and the earnings therefrom, as well as the income from the discharge and retirement of any of such bonds, will reim-

burse said fund for the amounts used in the expense of sales, the purchase of said stock and the expense of operating said business so that all bondholders will at the end of said 10-year retirement period be paid in full.

The Jefferson National Underwriters, Inc., was incorporated and organized in the latter part of 1936 and the early part of 1937, and the plan was set up, after consulting experienced actuaries, on a sound financial basis in the light of the then existing Federal and State laws.

The bond issued by Jefferson National Underwriters, Inc., was drawn very similarly to an endowment policy so that if any bond were surrendered prior to the fulfillment of all the payments or before the maturity date, the owner of the bond would receive certain surrender values, or at its maturity the face amount of the bond, to wit: $750 and 10 shares of stock of the Jefferson National Life Insurance Co. It was estimated that if the funds were invested on a 3-percent basis, which was a low rate of interest at that time, with normal lapses and ordinary increases in tax rates, every investor would have made a sound investment. Under the tax provisions beginning with 1939, some doubt arose as to the ability of this company to pay the then increased taxes and to pay their indebtedness in full.

With the subsequent increases in the tax rates following the year 1939 it became quite apparent that unless some relief was given to this company with regard to the two only items of income proposed to be affected that grave doubt might arise as to the ability of the company to pay the then increased taxes and to pay their indebtedness in full.

With the subsequent increases in the tax rates following the year 1939 it became quite apparent that unless some relief was given to this company with regard to the two only items of income proposed to be affected that grave doubt might arise as to the ability of the company and the depository to accumulate sufficient funds after payment of taxes with which to retire said bonded indebtedness.

With the proposed amendments in the absence of the relief we hereby request, it is quite positive that the Jefferson National Underwriters, Inc., will become insolvent and unable to retire said bonded indebtedness in full.

It could not pay the heavy normal tax, the heavy surtax, and the excess-profits tax as proposed without the relief sought and still be able to accumulate any earnings upon said deposited fund or from any other assets of the company that would approximate the amount necessary to retire said bonded indebtedness.

The relief we seek is for the aid of the creditors whose money is impounded in the deposited fund and whenever those creditors are protected either by discharge of their indebtedness or by the accumulation of a fund for payment of taxes sufficient to retire such indebtedness, the Jefferson National Underwriters, Inc., under our proposed amendment falls back in the same class with every other company and in the interim as to all other sources of income remains in that class.

The CHAIRMAN. Is there any further statement you wish to make?

Mr. COLERICK. No; I think not.

The CHAIRMAN. Mr. McKinney.

Mr. COLERICK. Mr. McKinney, have you something further to say?

Mr. MCKINNEY. No.

The CHAIRMAN. You may file a brief so we may get exactly your point.

Mr. McKinney does not wish to make a statement?

Mr. MCKINNEY. No, thank you, Senator.

Mr. COLERICK. I would be glad to answer any further questions.

The CHAIRMAN. Are there any questions that any member of the committee wishes to ask?

(No response.)

The CHAIRMAN. We thank you very much.

Mr. COLERICK. Thank you for your courtesy.

The CHAIRMAN. We will go into your matter.

Mr. Witherspoon.

STATEMENT OF JOHN A. WITHERSPOON, NASHVILLE, TENN., PRESIDENT, NATIONAL ASSOCIATION OF LIFE INSURANCE UNDERWRITERS

The CHAIRMAN. Give your name and your business connections.

Mr. WITHERSPOON. My name is John A. Witherspoon, Nashville Trust Building, Nashville, Tenn. It is my privilege to appear before you this morning as president of the National Association of Life Underwriters. Our organization which is 53 years old, has over 30,000 members who work in every State in the Union, District of Columbia, and Hawaii.

We have the privilege of representing 65,000,000 policyholders. I would like very much, sir, to get in the record that we represent the policyholders and not the companies.

When the revenue bill was pending before the Ways and Means Committee of the House of Representatives, the Treasury submitted, through Mr. Paul, but without recommendation, a memorandum of June 22, 1942, which dealt with the subject of fixed obligations of taxpayers and the treatment of certain types of fixed obligations in connection with the income-tax law. The question presented was whether Congress should amend section 24 (a) (4) of the Internal Revenue Code, so as to relieve from the high rates of the pending legislation, at least a reasonable sum employed by a taxpayer for such obligations as (1) debt retirement incurred prior to the present emergency; (2) subscriptions for the purchase of War bonds, and (3) premiums for insurance on the life of the taxpayer.

Admitted advantages of such a proposal are that the taxpayer would be helped to meet obligations which he should not avoid, would have an incentive to save and would assist in the avoidance of inflation. Our association is interested in all three objectives.

With increased taxes which are absolutely essential, constantly increasing cost of living, and a patriotic desire to cooperate with the Government on the 10-percent salary deduction for War bonds, it is going to be virtually impossible for many of the 65,000,000 people to maintain the life insurance they own today and pay their debts. Al-

most every taxpayer who owns his home has to pay real-estate taxes and interest on a mortgage and is entitled to deductions on account of such payments. Subscriptions to War bonds, amortization of debt, and insurance premiums are equally positive obligations and, within a reasonable limitation on the aggregate of all three, it would seem to us wise for this committee to grant a deduction for the amount siphoned off from ordinary income to meet charges of this character.

Unless individuals in both the low-income and middle-income tax brackets are granted some assistance in carrying their fixed obligations, including life-insurance premiums, it is virtually a foregone conclusion that the Government—which means the taxpayers—will have to support their dependents.

As you all know, our present income-tax law permits an individual to deduct up to 15 percent of his income for charitable purposes. This is a sound social measure and one which is certainly in the public's interest. But is it not also a fact that "charity begins at home"—that a modest income-tax deduction for life-insurance premiums would enable many of the American homes to remain as homes after the breadwinner is taken away. Mr. J. Edgar Hoover has stated that crime begins when the American home breaks down. I am sure you will agree that the American home breaks down when there is no money to hold it together.

It is my hope that you gentlemen in your wisdom, acting for and representing 130,000,000 people, will see the benefit and advantages of giving some relief from the present revenue act for life-insurance premiums, debt-retirement and war-bond purchases.

May I ask whether there are any questions before going on to another point? There is a second matter on which I wish to address you.

I have one other matter which I would like to discuss and address you on, but if you care to, sir, I will try to answer any questions on that one.

Senator TAFT. You used the phrase, "a modest income-tax deduction for life-insurance premiums." How would you translate that into figures?

Mr. WITHERSPOON. Of course, Senator, it all depends on whether you would take the three in an aggregate. The bonds, the debt retirement, and life-insurance premiums. If you take the life-insurance premiums separately, sir, we would suggest some figure of $300 or $500.

If you group them together, of course, it would be a very small deduction for the three items.

Senator VANDENBERG. I can agree with your objective, but I have been a little puzzled as to how to work it out.

Mr. WITHERSPOON. Yes, sir. I am sure the Treasury Department could furnish you the figures on the best way to work it out, sir.

Senator TAFT. If you take 5 percent of a man's net income, and suppose you take 10 percent which could be deducted on pre-existing debt, the limitation on pre-existing debt, what would you say of a life-insurance policy?

Mr. WITHERSPOON. I would say take the insurance purchased prior to the emergency. We are not trying to sell life insurance; we are trying to maintain it.

Senator TAFT. It seems to me if you do that you have got to let everybody else pay that 10 percent to the Government and perhaps get it back after the war. I do not see how a man who happens to have life insurance should be better off than a man who did not have it. As far as the income tax is concerned, I think you would have to give it an alternative reserve or something that would permit a man at least to get that 10 percent back from the Government after the war.

Mr. WITHERSPOON. I see, sir.

It might be very fine worked that way.

Senator TAFT. You might have an over-all limit. You could not exceed 10 percent for all three. After all, if you buy insurance, then you can borrow on the insurance to pay your debts.

Mr. WITHERSPOON. Yes, sir; that is correct.

Senator TAFT. Of course, the alternative could be to purchase a bond, but it seems to me it would be almost better to let the Government take it and pay it back later, if the Government gets it without interest.

Mr. WITHERSPOON. Of course, our point is, Senator Taft, that the method of purchasing the life insurance gives such a tremendous social implication to families in case the broadwinner does die.

Senator TAFT. It is also true that payments on debts gives somebody else money to buy Government bonds with. In other words, they have a deflationary effect.

Mr. WITHERSPOON. That is correct.

Senator TAFT. Also payment of life insurance gives it to the insurance companies. They are now investing practically all of their money in Government bonds.

Mr. WITHERSPOON. That is correct.

Senator RADCLIFFE. Has this allowance you suggested ever been made in any taxing system in this country? Or any other country, as far as you know?

Mr. WITHERSPOON. Not in this country, as far as I know, but England has had an exemption for many years and so has Australia.

Senator RADCLIFFE. Do you know on what basis that is?

Mr. WITHERSPOON. In Australia it is on the basis of 100 pounds, which is $480. The English is on a sliding scale, as I understand it.

May I proceed with my second point, Senator?

The CHAIRMAN. Yes, sir.

Mr. WITHERSPOON. The bill as passed by the House amends the estate-tax statute by increasing the general exemption from $40,000 to $60,000 and removing the $40,000 exclusion for insurance payable to beneficiaries other than the estate of a decedent.

On Friday a week ago, July 24, testimony was given before this committee to the effect that the removal of the $40,000 life insurance exclusion in estate taxes which has been in the statute since 1918 would cost the Government $15,000,000.

Therefore, the proposal to remove the $40,000 could not be dictated by desire for revenue. The social implications of life insurance are so widespread that they touch more than three-fourths of the population in the United States. For over 100 years life insurance has proven that for the vast majority of the people it is the only means whereby one can make reasonable provision for his family.

Life insurance helps to build up a cushion for future readjustments. First of all let us approach the question from the standpoint of the

responsibilities of the insured during his lifetime. If we are to learn anything from the 1931–32 era we know that with jobs scarce men with fixed obligations who were out of work had to fall back on accumulations. Many of them fell back upon their accumulations in life insurance moneys which they had siphoned off from excess earnings during the 1920's. The excess earnings they siphoned off in the 1920's and placed with the life-insurance companies were a godsend to them for the necessities of life, food, shelter, and clothing—during 1931 and 1932 when jobs were scarce.

Approaching secondly from the standpoint of the period after the death of the insured.

Life insurance helps to build up a cushion for future readjustments. It meets the obligation of the decedent to care for those after his death who have been provided for by him while he was alive. During his lifetime the income-tax law granted him a reasonable allowance for the support of his dependents and if he was a married man or the head of a family gave him a larger exemption before taxes took effect. These same dependents survive him and find it very difficult after the provider is gone. Certainly no one can quarrel with the conclusion that something equivalent to the allowances for dependents should be carried through to bridge over the period after death until the family is self-sustaining.

Unfortunately, life insurance is seldom sought. Therefore, people must be educated to its advantages. For nearly 25 years Congress has given approval to an exclusion which has been an important factor in this educational program.

In the $40,000 exclusion there is a needed incentive not only to accomplish the things listed above from a social aspect but also to furnish liquid funds to pay death taxes to the Government. We know that these taxes must be paid either out of liquid funds or forced sale in many instances of accumulated property. The latter, of course, is costly to the individuals as very few people ever die at the right time, economically.

We therefore urge this committee to retain the $40,000 exclusion which if invested at 3 percent will only yield $1,200 a year or $100 a month—a bare existence for any widow, especially one with children.

Instead of the proposed combining of the $40,000 general exemption and the $40,000 exclusion on life insurance to a $60,000 general exemption, we urge you to retain the present law with the $40,000 life-insurance exclusion which citizens have been led to believe that Congress would maintain.

May I point out to you gentlemen that these 65,000,000 policyholders who have accumulated savings of over $30,000,000,000 have made it possible through the investment of these voluntary savings to help this Nation in building the greatest industrial system which any nation in the world has enjoyed?

Life-insurance institutions held at the end of 1941 about $7,000,000,000 of policyholder funds in Federal Government securities, and during this year of 1942 it is estimated that another $2,500,000,000 of such funds will be invested in Federal Government securities. Undoubtedly you gentlemen will be interested to know, and the Treasury Department will substantiate this statement, that the life insurance men and women of America, working with and through the Treasury Department, and under the leadership and guidance of the National Asso-

ciation of Life Underwriters have sold, since January 1, 1942, over $1,000,000,000 of the series E War bonds through the salary-allotment plan.

During the last 10-year period the life-insurance companies paid out to policyholders and beneficiaries some $26,000,000,000. This money was paid out, not at the cost of the taxpayers, but from the savings, thrift, and sacrifice of policyholders.

When our association appeared before the Ways and Means Committee on April 9, 1942, several other suggestions were made for consideration in connection with this bill. They include:

(1) An amendment of section 811 (g) of the Internal Revenue Code so as to obtain a statutory rule that insurance is not to be included in gross estate of a decedent if he has completely parted with all of the incidents of ownership prior to his death and not in contemplation of death.

(2) A suggestion that life-insurance proceeds earmarked for the payment of Federal estate tax should not be included in gross estate.

(3) The amendment of section 22 (b) (2) of the Internal Revenue Code so as to make it clear that the exemption of insurance proceeds from income tax under section 22 (b) (1) will include proceeds of a policy taken over for valuable consideration if the beneficiary of the policy is dependent upon the bounty of the insured or is closely related to the insured or he has an insurable interest in the insured.

Those last-mentioned questions I will leave for discussion by Mr. Lawrence Baker, our attorney who will follow me as a witness. Mr. Baker is here.

I shall be very happy to try to answer any questions that any of you may care to ask with respect to the two proposals that I have discussed.

Senator BAILEY. Do you propose to allow a deduction of a certain proportion of insurance premiums?

Mr. WITHERSPOON. Yes; from income tax.

Senator BAILEY. Insurance is an investment, is it not?

Mr. WITHERSPOON. Well, from one standpoint; yes. From another; no, sir. It is an indemnification for loss.

Senator BAILEY. Is insurance an investment or not?

Mr. WITHERSPOON. An endowment policy is, sir. An ordinary life policy is not. It is an indemnification for losses.

Senator BAILEY. The ordinary life policy has some accumulated value.

Mr. WITHERSPOON. Yes.

Senator BAILEY. Let us get down to the facts.

Mr. WITHERSPOON. All right, sir.

Senator BAILEY. Insurance is an investment. If you are going to exempt or allow deductions for one kind of investment, why not allow me to deduct for investment in real estate?

Mr. WITHERSPOON. May I just make this observation, sir?

Other types of investment are bought for personal gain, as a rule.

Senator BAILEY. No; they are bought for protection, just like insurance is. A man makes a personal gain, he tries to save something if he is a normal human being.

Mr. WITHERSPOON. My point was that they bought to get an income during their lifetime.

Senator BAILEY. I bought the real estate to give something to my wife and children when I die, did I not?

Mr. WITHERSPOON. Yes.

Senator TAFT. You are proposing to let him deduct some part of the payment made on that debt, and you are also confining your proposed exemption to life insurance, to obligations assumed prior to the emergency.

If there was such an alternative provision, you would put all the investments on the same basis, if the obligations were incurred prior to the emergency?

Mr. WITHERSPOON. That is correct.

Senator TAFT. If you had not assumed any such obligations, you could buy Government bonds, or set aside the amount to apply to Government bonds.

Mr. WITHERSPOON. That is correct.

The CHAIRMAN. In other words, your deduction, in computing the net income, is a deduction to be allowed and that deduction could be absorbed by the purchase of bonds and/or the payment to life-insurance funds, and/or the payment for previous debt obligations.

Mr. WITHERSPOON. That is right.

The CHAIRMAN. I think you are very sound on it; I think you are essentially sound on it, in view of the high rate of taxes.

Mr. WITHERSPOON. Yes, sir; and the increased cost of living, too.

The CHAIRMAN. Is there any way, without doing irreparable harm and injury to people, large numbers of whom have endeavored to create an estate in some insurance fund of some kind?

Mr. WITHERSPOON. Correct, Senator.

The CHAIRMAN. All right, sir.

Senator RADCLIFFE. Have you ever presented this idea prior to this year?

Mr. WITHERSPOON. As to the income-tax deduction?

Senator RADCLIFFE. Yes.

Mr. WITHERSPOON. No, sir.

Senator DANAHER. I have one question, Mr. Chairman, please.

The CHAIRMAN. Yes.

Senator DANAHER. Does the witness know the history of why $40,000 was taken as an exemption figure?

Mr. WITHERSPOON. Well, as I understand it, it was exempt up to the 1918 revenue bill. And then it was put in to have a fixed amount, so as not to have the limited amount on insurance.

Senator DANAHER. Do you know any other reason for that than that?

Mr. WITHERSPOON. I think the social reason was it would give a man the right to leave some liquid funds to his wife and children, to indemnify them for the loss of his earnings.

Senator DANAHER. Thank you.

Senator BAILEY. When the estate tax got up to the high brackets—in those days it was 25 percent—the high rate induced people not to insure, because so much was taken. It was first $60,000 and then it was reduced to $40,000.

Mr. WITHERSPOON. Yes.

Senator DANAHER. Does that not coincide also with the upper limits of the estate taxes?

Senator BAILEY. I do not know about that. I happen to know something about the history of the 1918 act.

The CHAIRMAN. Thank you very much for your appearance. We have time, I think, for one additional witness before recessing.

Mr. Baker.

STATEMENT OF LAWRENCE A. BAKER, WASHINGTON, D. C., REPRESENTING THE NATIONAL ASSOCIATION OF LIFE INSURANCE UNDERWRITERS

Mr. BAKER. My name is Lawrence A. Baker, the American Security Building, Washington, D. C.

Before addressing myself to the two or three points that Mr. Witherspoon remarked on, I would like to take up for just a minute the matter that was being discussed by Senators Bailey and Danaher. I have here before me the report of the Ways and Means Committee, which accompanied the revenue bill of 1918, and it contains the reasons then assigned by the committee for the treatment of the $40,000 exclusion.

For some months at that time I happened to have been assigned by the Treasury, where I was the head of the estate-tax division, to cooperate with the committee in the preparation of its report and in the drafting of the law.

The Commissioner of Internal Revenue had called to the attention of the Congress the fact that although insurance included in the estate of a decedent was included by reason of the fact that it was liable for the debts of the decedent, it had not been mentioned in the act itself. It was thought well to include insurance as one of the items specifically in the estate of the decedent, if it was payable to the executor or the legal representative of the decedent.

A second problem existed with respect to insurance that was payable to specific beneficiaries, an entirely different question, because it had not been comprehended when the 1916 law was passed, that insurance which was payable to specific beneficiaries was in any sense part of the decedent's estate.

Because of that general conception, that insurance payable to specific beneficiaries was outside of the estate, insurance agents were making representations to wealthy people that it was a convenient means of tax avoidance, and so something had to be done about it.

The committee said:

> The provisions with respect to specific beneficiaries has been included for the reason that insurance payable to such beneficiaries usually passes under a contract to which the insurance company and the individual beneficiary are the parties in interest and over which the executor exercises no control. Amounts passing in this way are not liable for expenses of administration or debts of the decedent and therefore do not fall within the existing provisions defining the gross estate. It has been brought to the attention of the committee that wealthy persons have and now anticipate resorting to this method of defeating the estate tax. Agents of insurance companies have openly urged persons of wealth to take out additional insurance payable to specific beneficiaries for the reason that such insurance would not be included in the gross estate.
>
> A liberal exemption of $40,000 has been included and it seems not unreasonable to require the inclusion of amounts in excess of this sum.

In other words, it was regarded by the committee at that time that there would not be inducement to avoidance if the amount that was excluded amounted to $40,000.

The CHAIRMAN. It was put in as an alternative?

Mr. BAKER. It was put in as an alternative and was regarded as an amount which a person could conveniently take out, and properly could take out, without being charged with employing that method of tax avoidance.

That has never been changed since that time, and no suggestion has been made that it be changed since that time, until the present revenue questions arose.

Senator CONNALLY. Under this bill, if it passes, a wife might have a million dollars of insurance payable to her which formerly was not regarded as part of the estate at all, and yet, under this bill, he could only get a credit of $40,000; is that right?

Mr. BAKER. Under this bill he might get a credit of $60,000, if he had no other property.

Senator CONNALLY. But it does tax these policies, regardless of whether they are payable to the estate or whether they are payable to special beneficiaries?

Mr. BAKER. That is correct.

The distinction between insurance payable to the executor, to be used as the estate pleases, and insurance payable to other beneficiaries is broken down by the Treasury proposals. All of it becomes includable in the estate.

Senator CONNALLY. That has been true since 1918, has it not?

Mr. BAKER. Not in respect to the $40,000. The $40,000 has been out since 1918, if it was payable to specific beneficiaries. It has been exempt; it has not been included in the estate.

As Mr. Witherspoon pointed out, the association feels that there is an incentive situation with respect to the $40,000 exclusion. In addition to the incentive situation, it is an amount which can be allowed and granted without the charge of tax avoidance being imposed, because presumably the small amount of yield which comes from that much insurance is a reasonable amount to grant in any situation.

May I say with respect to these other proposals, this organization that Mr. Witherspoon heads and for which I appear, and have appeared a number of times before, is a representative organization. We receive our suggestions from agents throughout the country, based on representations that are made to them by their policyholders.

They relate to problems that are raised here not because some individual connected with this organization or association necessarily believes in them, nor are they always presented to you because we believe we have the right answer, but we do present them to you because we believe that in the case of these particular proposals they have enough merit and have come to us with sufficient support from the policyholders, who, indirectly, are putting their pressure, if I may say so, on us to bring them to your attention so you may consider them—we believe they are all worthy of your thought. I make that suggestion because I realize that this is no time when we should be asking for special treatment, a treatment which would operate to drive the revenue down, and especially would drive it down on the basis of any discrimination in favor of particular people. On the other hand, we must not let our anxiety about the revenue and the question of discrimination defeat a fair opportunity to consider something which is sound eco-

nomically and in the interest of the country generally. I think, in connection with this $40,000 of exemption, I should call your attention again to the fact that when the association appeared before the Ways and Means Committee they asked for further consideration on the question of whether, if insurance was earmarked, specifically earmarked to pay the tax, that it should receive the benefit of an exclusion rather than the imposition of the very heavy tax that comes on the high bracket and is now defeating the purchase and sale of that kind of insurance.

No man having an estate of $300,000 in brick and mortar, with $40,000 provided for his family against the possibility that his business is not going to survive, can go out and buy the additional $60,000 to bring the $40,000 and $60,000 up to the $100,000 which is collectible from his estate without paying the Government another $50,000 on top of the $100,000; so that, today, if a man goes out to buy the insurance that is necessary to insure the payment of the tax because his estate is frozen in a going business and he only has insurance excluded for his family to the extent of the $40,000, he must pay a premium that is required to take care of $150,000, and he has got to pay an estate tax of $50,000 to the Government in order to carry the $100,000—the insurance cannot be bought on that basis, and it will not be bought on that basis.

So I say the granting of the exclusion, where it is earmarked in this way, is not the granting of an exclusion at all. It is making a means available which otherwise cannot be employed.

Senator VANDENBERG. That is a reciprocal advantage to the Government. I should think it permits an immediate liquid determination of the estate-tax obligation.

Mr. BAKER. It has that great advantage. It also has this great advantage, Senator Vandenberg: If the man's business is frozen and is going to be destroyed by the collection of the inheritance tax, his specific beneficiaries could never be expected to kick in the $40,000 that they have, that has been left to them free and clear. They will let the business go and do what they can with what is left; whereas, if you do permit the decedent in his lifetime to build up a fund without thinking that when he dies that fund has got to be 50 percent greater in order to take care of an additional estate tax—if you do not include that and you have the additional $60,000 the beneficiaries who are the owners of that prosperous business will have the fund of $100,000, and the $40,000 might be kicked in, because there is a chance of saving the business and it might go on. The sons may be employed in it.

Senator RADCLIFFE. Are you suggesting any limit to the amount of insurance that should be made available?

Mr. BAKER. Senator Radcliffe, this committee on past occasions, when the emergency was not upon us, twice considered this proposal, and I think the last time they passed the proposal, the limitation was $250,000.

We would never suggest such a figure. I think it is fair to say if an amount which, when added to the insurance payable to the specific beneficiaries up to $100,000 were excluded you would be taking care of most of the hard cases, of the smaller businessmen, and at least helping them over the bridge.

That class of case would not hurt the revenue, because the insurance would not be bought if they did not have that opportunity.

Senator RADCLIFFE. Of course, the point might be made that the funds used for the purchase of premiums under such conditions might be concluded as an impairment of the assets of the estate by so much; in other words, if the money used for the purchase of the premiums was allowed to remain in the estate at the time of the death of the decedent, the estate would be increased by a corresponding amount.

Of course, that might or might not be the case. Have you ever considered the possibility of allowing actual credit only for the excess of the amount of the policies over the aggregate of premiums paid in?

Mr. BAKER. That has been considered, Senator. At one time I think the Senate Finance Committee was very much impressed with that idea. I think the Treasury Department was very much impressed with it. What we are concerned with here is not the existing situation where reserves have been built up and where a large sum is already in the insurance pockets, so to speak, what we are interested in is taking care of an emergency where your estate-tax rates are so high that if you do not give a man a chance to go out and protect against the tax by this method, he probably cannot protect against that at all.

In the case of a corporation of which he is the sole proprietor, if it is making a substantial sum of money, most of it is going to be taken away from him under the income and excess-profits tax rates of this bill. If his company does not distribute the money that is left, it has an undistributed-surplus tax problem. If it does distribute the money, the individual stockholder is again faced with high surtax brackets. He cannot take out of the income that is left, after his sole proprietorship and his personal returns have been filed, enough money to set up the reserves that are required.

So, if you do not do something else, it is our feeling—and I say it is not my feeling or the feeling of the officers of this association, it is the feeling of thousands of people who are pressing us to bring it to your attention—that this is a solution that you ought to seriously consider. You may find that you cannot do it, but certainly I hope you will consider it.

Senator RADCLIFFE. I think there is very much merit in the idea but certainly if there is a restriction to the excess on the face value of the policies over the contributions made, no one in the world could claim that the estate had been depreciated by the payment of the premiums.

Mr. BAKER. There might be a combination, Senator, of that suggestion with the suggestion that insurance bought for that purpose might be treated slightly differently. That is, if a man has insurance that he wants to convert to that purpose and he is depleting his estate by having created a reserve that would have been taxable before this emergency came on, then possibly you ought not to let him have the advantage of that sum, but when you come right down to it, when you put the limitation of $100,000 on the whole thing and charge the $40,000 to specific beneficiaries up against it, you are dealing with $60,000 which is not a large sum to worry about. You ought to try the thing out and see what the experience is going to be. I should be very much

surprised and I should think the members of this committee would feel the same way, if after this thing became effective, you did not find that your income-tax revenues might be better protected and even increased because of the continuation of these concerns which we are all worried about.

Senator RADCLIFFE. I should think if a plan like that could be worked out, it would be beneficial to the estate and would certainly prevent these numerous liquidations of estates consisting of a going business, the liquidation of course resulting from the necessity of paying the estate taxes.

Senator BROWN. The Treasury Department estimates the losses by reason of the change in the estate taxes is a little over $14,000,000. Is any part of that loss attributable to this change in exemptions?

Mr. BAKER. That loss is attributable partially to the change in exemptions, I should think.

We were never supplied with their figures. We do not know what the effects of it were.

We attempted at one time to get figures on what the loss might be on the earmarking proposal.

Senator BROWN. The figures are shown on page 3 of the Ways and Means Committee report. You seem to be well informed on the subject. In your judgment, will this change in exemptions result in a loss of taxes to the Government over the present loss?

Mr. BAKER. I think it will result in that loss, because the incentive to take the insurance will be diminished and the natural inclination will be to say "Why should I take the insurance if I can have $20,000 more in my general exemption?"

Senator DANAHER. Mr. Baker?

Mr. BAKER. Yes.

Senator DANAHER. With reference to the subject you were discussing with Senator Radcliffe, what is your view of section 404, at page 557, of our bill, beginning at the bottom of page 256? That is in the estate-tax section.

Mr. BAKER. You have in mind particularly the assignment question, Senator Danaher?

Senator DANAHER. No. You see, we are amending the estate- and gift-tax section in title IV. It commences on page 251, and we are amending the general rule stated in section 811 with reference to premiums paid directly or indirectly by the decedent, and the amount that the estate tax would apply to as the result.

As to the insurance that is receivable by the executor as insurance under policies upon the life of the decedent, that is to be taxed outright?

Mr. BAKER. Yes.

Senator DANAHER. As to other beneficiaries, an allowance is made of the amount that the premium has been paid by the decedent himself.

Mr. BAKER. I think the provision is aimed at a tax-avoidance plan which is cured, and we would subscribe to the propriety of the amendment.

Senator TAFT. This is the amendment which changes the $40,000, is it not?

Mr. BAKER. No; not this particular amendment.

Senator TAFT. Does it not have that effect?

Mr. BAKER. No.

Senator TAFT. It includes in the estate all policies, even if held by the beneficiaries, if the insured paid the premium. Of course, if somebody else paid the premium, they would not be in the estate.

Mr. BAKER. I will come in a minute, Senator Danaher, to a discussion of this section 811 which is tied up with the amendment which you speak of.

The present section 811 (g), I think it is, of the Internal Revenue Code is aimed at by the amendment to which you call attention.

Heretofore, and for many years, the Treasury Department had taken the position, until January 1941, that if all of the incidents of ownership of an insurance policy were transferred and the person who took out the policy, the prospective decedent, had nothing left in the way of a property interest in the policy, it could not be included in the estate of the decedent. The Treasury Department amended its regulations on that score and determined that policies would be regarded as having been taken out by the decedent if he paid the premiums.

The amendment was not made retroactive but was made effective in respect of transfers that took effect after a date in January 1941, and where any incidents of ownership were retained after the transfer, the proceeds of the policy were included to the extent that the premiums were continued to be paid by the decedent—that is, the prospective decedent, of course.

The Treasury is now proposing to include in the estate of the decedent the proceeds of the policies if any of the incidents of ownership in the policy were still in the insured, or if he continued to pay the premiums.

We think that there is a bad discriminatory objection, a serious discriminatory objection to the provision. It is inevitably going to lead and is leading to the transfer of insurance under conditions which make is possible for somebody else to pay until the operation of this statute would come in, and then the insurance would be surrendered and a new insurance would be taken out by a member of the decedent's family who would have the means to pay for it.

A man with a rich wife is not going to be hurt by this change, because he can give up his insurance and his wife can go out and buy insurance again. You cannot possibly include in a decedent's estate the proceeds of a policy which are paid to someone who has paid the premiums out of his own pocket but who has an insurable interest in the decedent.

At least our statute has not gone that far yet.

Senator TAFT. If you go back to the $40,000 proposition, you would have to amend subsection (2), on page 257; would you not?

Mr. BAKER. Yes; this would have to be changed. You are quite right, Senator.

I am sorry. I was confused at first when I said we gave assent to this provision.

I did not realize at the moment exactly what it related to.

Senator DANAHER. If you were confused, you are just sharing a common attitude and aptitude.

The CHAIRMAN. All right, Mr. Baker.

Mr. BAKER. In order not to detain the committee too long, Mr. Chairman, I would call attention to the fact that representations on

behalf of this association were made before the Ways and Means Committee, and there was a carefully prepared exposition on this provision, section 811 (g) inserted in the House hearings.

The material appears, beginning at page 2363 of the hearings by the Ways and Means Committee on Revenue Revision of 1942, and the committee might refer to those hearings and save the time of having me go into it any further here. If the committee prefers, I have a copy of it here, and you can have it.

Senator CONNALLY. I suggest you leave it with the clerk so we can see it in executive meetings.

The CHAIRMAN. All right.

Mr. BAKER. There is one other small amendment. I say "small," but it seems to be very important to a great many people. It is not important in terms of revenue, certainly not so important as the other matters that I have been discussing.

That is the question of amending section 22 (b) (2). That is in connection with a reorganization which is a tax-exempt reorganization on account of continuity of interest, where insurance policies are transferred.

The continuity of interest or the right of the appointee of the insured would justify you in treating that type of insurance exactly like any insurance originally taken out by a corporation. If a corporation presently takes out insurance on the life of its officer, it is not allowed to deduct the premiums paid on that insurance and when the proceeds come in they are treated—have been treated for years, since the decision by the Supreme Court in the *Supplee-Biddle case*—as not taxable income.

On the other hand, if corporation A is merged with corporation B, A goes out of business and is taken over by some group of companies and the benefits of that policy go with the transfer of assets, the Treasury now takes the position that that is substantially equivalent to a sale and throws it out of the category of the other nontaxable transactions that took place in connection with that reorganization.

It says it shall be treated just exactly as though some stranger came in and bought that policy, and he must take the cost off against the proceeds and treat the difference as gain. That question also is considered, from its technical standpoint, and a suggested amendment is included in the House hearings.

The CHAIRMAN. Yes, sir.

Mr. BAKER. Are there any other questions?

Senator BAILEY. I want a little information. I read in the paper that 65,000,000 individuals were carrying life-insurance policies at the present time in this country. Is that right?

Mr. BAKER. That is the best information on the subject. Mr. Witherspoon included that in his statement.

Senator BAILEY. That includes industrial insurance?

Mr. BAKER. I assume that includes industrial insurance. Although I am not an economist, I have studied the figures, but I would not be sure that it does include industrial insurance. That may relate only to individual policyholders.

Senator BAILEY. The amount of insurance of course in 1936 was $110,000,000,000 for the approximately 60,000,000 to 65,000,000 people.

Can you tell me what the amount of life insurance that is now in force is?

Mr. BAKER. I do not have that.

Senator BAILEY. I would like to have it in the record.

Mr. BAKER. I will see that it is supplied in the record.

Senator BAILEY. I want to see if it has increased.

Mr. BAKER. I think it has increased.

The CHAIRMAN. Thank you very much.

(The information requested of Mr. Baker is as follows:)

BAKER, SELBY & RAVENEL,
Washington, August 25, 1942.

Hon. JOSIAH W. BAILEY,
United States Senate, Washington, D. C.

MY DEAR SENATOR BAILEY: At the conclusion of my testimony before the Senate Finance Committee on August 4, 1942, you indicated your desire to have in the record of the hearings the total amount of life insurance now in force and I undertook to obtain this information for you.

From reliable sources I have learned that the total amount of insurance in effect December 31, 1941, was, in round figures, $124,000,000,000. Estimates which may be regarded as approximately correct indicate that on July 1, 1942, the total had increased to $128,000,000,000.

Both of the foregoing estimates include life insurance taken out for the benefit of those employed in industry.

I am handing a copy of this letter to the clerk of the committee.

Very truly yours,

LAWRENCE A. BAKER.

The CHAIRMAN. The committee will recess until 2 o'clock.

(Whereupon, at the hour of 12:40 p. m. the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

(Whereupon at 2 p. m., the committee met pursuant to recess.)

The CHAIRMAN. The committee will come to order.

Mr. Anderson, Mr. C. V. Anderson.

(No response.)

The CHAIRMAN. Mr. Barton. We will call you. Mr. Anderson doesn't seem to be in right at the moment.

STATEMENT OF WALTER E. BARTON, WASHINGTON, D. C., REPRESENTING A GROUP OF FLORIDA LIFE INSURANCE COMPANIES

The CHAIRMAN. Mr. Barton, you may proceed.

Mr. BARTON. Gentlemen, I am Walter E. Barton, of Washington, and I am representing some Florida life insurance companies—the Swanee Life Insurance Co., the Independent Life & Accident Insurance Co., the United Life Insurance Co., the Professional Insurance Corporation, the Guaranty Life Insurance Co. of Jacksonville, and the Central Life Insurance Co. of Tampa. These companies are interested in the new definition of a life-insurance company which is section 201 (b) of the Internal Revenue Code, as amended by section 145 of the House bill, where on page 20 of the House bill——

Senator BROWN. Page what?

Mr. BARTON. Page 120—they eliminated from the definition of a life-insurance company a burial or funeral-benefit company.

Representatives of the Florida companies—and representatives of the Louisiana, Alabama, and Tennessee companies, have been in conference with representatives of the Treasury Department regarding this matter. The Treasury has proposed two amendments—either one they said would be acceptable to the Treasury Department—and we have gotten together and agreed upon one of the amendments with the Treasury Department, and Mr. Stam, of the Joint Committee on Internal Revenue Taxation, suggested inasmuch as I had already arranged some time before this agreement was reached, that I come over here and explain what it was, for the record of the committee.

The CHAIRMAN. First, is your company subject to regulations by the State?

Mr. BARTON. Yes, sir.

The CHAIRMAN. Regulations?

Mr. BARTON. Our companies, I think, are in a whole lot better position than some of the others, because, while they grew up and were called, in Florida, sick and funeral benefit companies, in 1935 the Florida Legislature required them thenceforth on all new policies to pay in cash, and all of these companies that I represent pay nothing but cash, except I think two of them have a small number of old policies that are still in force, in which they provided for the payment of funeral benefits.

The CHAIRMAN. Well, you say you have the definition that has been agreed upon.

Mr. BARTON. Yes, Mr. Senator.

The CHAIRMAN. If you will give us that.

Mr. BARTON. The agreement is: On page 120 of the House bill to strike out the words in parentheses "other than a burial or funeral benefit company", entirely, and at the end of that section, at the end of the fifth line on page 121 of the bill, insert this language:

> For taxable years beginning after January 1, 1944, a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxed under this section, but shall be taxed under section 204 or 207.

Section 204 pertains to insurance companies other than life or mutual. For instance, a stock insurance company—that is, not a life-insurance company—and section 207 pertains to mutual companies other than life.

It is also proposed to amend section 204 (b) (5) of the Internal Revenue Code by inserting at the end of that, this language:

> For the purpose of this section unearned premiums shall include life-insurance reserves as defined in section 201 (c) (2) pertaining to life, burial, or funeral insurance, or annuity business of insurance companies not qualifying as life-insurance companies under section 201 (b).

Of course, the purpose of that is if a funeral benefit company can't qualify as a life-insurance company, it goes over under section 204, then it gets the benefit of a deduction as unearned premium which it would have gotten as a life-insurance reserve if it stayed under section 201 (b).

I have written a letter to the Treasury Department agreeing to this amendment on behalf of the Florida insurance companies, and the

representatives of the Louisiana and Alabama and Tennessee companies are going to write similar letters agreeing to it.

I thought I would have copies of their letters this morning, before I came up, but they hadn't reached me, and I would like to submit a copy of my letter to the Treasury Department regarding the matter, to be included in the record.

The CHAIRMAN. What is the effect of it all?

Mr. BARTON. Well, the effect of it all is this, Senator: From the House report it was apparent that the House was under the impression that all so-called funeral benefit companies were not writing life insurance, but were merely paying and furnishing services and merchandise in the event of death.

The CHAIRMAN. Yes; I understand that.

Mr. BARTON. Well, that is not true. I just stated that in the case of our companies they do not. They pay in cash. The policyholders can take that $250 or $500—$500 is the limit—and there are no strings tied to it. They can go out and use it for burial purposes or any other purposes. But inasmuch as our companies might, under Florida law, still be classified as sick- and funeral-benefit companies, we didn't want to take any chances, and inasmuch as they pay nothing but cash and maintain reserves the same as any other life-insurance companies, we wanted this language to be clarified so they could continue to be taxed as life-insurance companies which the committee of the House intended to undo by virtue of throwing out of the definition "all funeral-benefit companies."

The CHAIRMAN. These two amendments that have been agreed upon, do they accomplish that purpose?

Mr. BARTON. They will accomplish that purpose insofar as our companies are concerned and the postponement until January 1, 1944, will give some other companies that might not at this time be in just such a good situation, time to readjust their business so that they can qualify under the definition.

The CHAIRMAN. Very well, sir. You can put what you have read in the record.

Mr. BARTON. I haven't read this.

The CHAIRMAN. What was it you wanted to put in the record?

Mr. BARTON. It is attached to that statement I believe you have. That may go in the record?

The CHAIRMAN. Yes. Thank you.

Mr. BARTON. Thank you, sir.

(The following letter was submitted by Mr. Barton:)

WASHINGTON, D. C., *August 1, 1942.*

THOMAS TARLEAU, Esq.,
Tax Legislative Council, Treasury Department,
Washington, D. C.

DEAR SIR: In compliance with the request of Mr. Milton Friedman, with whom conferences have been held with certain representatives of the industrial life insurance industry relative to the definition of a life-insurance company contained in section 201 (b) of the Internal Revenue Code as amended by section 145 of the House revenue bill of 1942, this is to advise you that the following amendments proposed by the Treasury Department are acceptable to the Suwannee Life Insurance Co., the Independent Life & Accident Insurance Co., United Life Insurance Co., Guaranty Life Insurance Co., and Professional Insurance Corporation of Jacksonville, and the Central Life Insurance Co. of Tampa, Fla., which I represent:

Strike out the parenthetical words "(other than a burial or funeral benefit company)" beginning in the third line of section 201 (b) of the Internal Revenue Code as amended, which are on page 120 of the House bill; and at the end of said section, following the word "law" in the fifth line on page 121 of the House bill, insert the following sentence:

"For taxable years beginning after January 1, 1944, a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxed under this section but shall be taxed under section 204 or 207."

Amend section 204 (b) (5) of the Internal Revenue Code by adding at the end thereof the following:

"For the purpose of this section, unearned premiums shall include life-insurance reserves as defined in section 201 (c) (2) pertaining to life, burial, or funeral insurance, or annuity business of insurance companies not qualifying as life-insurance companies under section 201 (b)."

At these conferences with Mr. Friedman an explanation of the change made in the House bill by the Senate committee was discussed. It seems to me that either of the attached explanations would cover the situation.

At a conference with Colin F. Stam, Esq., chief of staff, Joint Committee on Internal Revenue Taxation, he stated that any amendments agreed upon by the Treasury Department and representatives of the companies would be acceptable to him. At this conference with Mr. Stam he was informed that I had arranged to appear before the Senate Finance Committee on August 4 on behalf of the Florida companies. In view of the agreement which we have reached with reference to the form of the amendments, he suggested that I appear before the committee and file a short brief relative to the understanding.

Respectfully yours,

WALTER E. BARTON.

Enclosures, 2.
Copy to Colin F. Stam, Esq.

FIRST EXPLANATION

The original intent for the exclusion of a burial or funeral benefit company from classification as a life insurance company was to require payment of tax on income from manufacture of supplies and performance of services. The object is accomplished if this work is done by others, including subsidiaries or affiliates. The effective date of the change in classification is deferred to enable such companies to rearrange their methods of doing business where necessary.

SECOND EXPLANATION

The original intent for the exclusion of a burial or funeral benefit company from classification as a life insurance company was to require payment of tax on income from manufacture of supplies and performance of services. Ownership or control of the majority stock of a corporation engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be construed to mean that the burial or funeral benefit insurance company is directly engaged in the manufacture of funeral supplies or the performance of funeral services within the meaning of this act. The effective date of the change in classification is deferred to enable such companies to rearrange their methods of doing business where necessary.

The CHAIRMAN. Mr. C. V. Anderson.
(No response.)
The CHAIRMAN. Mr. Christensen.

STATEMENT OF C. M. CHRISTENSEN, AUDITOR AND COMPTROLLER, TRIUMPH MINING CO., TRIUMPH, IDAHO

Mr. CHRISTENSEN. Mr. Chairman.

The CHAIRMAN. Yes, sir, Mr. Christensen, what particular feature of the tax bill are you speaking to?

Mr. CHRISTENSEN. It is an administrative measure, pertains primarily to some of the old features, features in the old tax law, but which have been touched upon in the new House bill.

The CHAIRMAN. All right. You may sit down or you may stand; just as you wish.

Mr. CHRISTENSEN. My name is C. M. Christensen. I am auditor and comptroller of Triumph Mining Co., of Triumph, Idaho, a producer of zinc and lead, and while I represent specifically the Triumph Mining Co., I speak also for all other "acquiring corporations" which chance to be in the same position. My talk is with reference to section 213 of H. R. 7378 which amends section 722, granting relief to certain qualifying corporations, and section 216, making certain amendments to supplement A of the Excess Profits Tax Act.

It was my privilege to spend considerable time on several occasions during 1941 with members of the legislative branch of the Treasury Department and the Bureau of Internal Revenue, and members of the staff of the Joint Committee on Internal Revenue Taxation. I secured from these persons some rather definite assurances that recommendations would be made to Congress for the passage of administrative amendments which would effect the relief to which this corporation was admittedly entitled.

These assurances included the provision that such recommended amendments would be made retroactive to the beginning of the Excess Profits Tax Act. However, as you gentlemen know, various conditions arose making it inadvisable or impossible for Congress to consider administrative changes in last year's revenue bill. The admitted inequities have, accordingly, been allowed to remain in effect until the present time.

The exact conditions pertaining in the application of the 1940 and 1941 Excess Profits Tax Act to this corporation are set forth in full detail in a presentation which I made to this committee, in writing, on August 20, 1941, as recorded on pages 1024 to 1026—part 9 of your record of hearings. I quote that portion which describes the peculiarities of this corporation.

Section 741 grants to corporations known as "acquiring corporation" the election to use either section 713 (the income method) or section 714 (the invested capital method) in computing their excess profits tax credit. But section 740 which defines "acquiring corporations" eliminates all corporations which came into existence as a result of having acquired only a portion or portions of the assets of predecessor transferor corporations. The Triumph Mining Co. is such a corporation and is thus deprived of its rightful privilege of using its own base period income in computing its excess profits tax credit.

For several years prior to 1940 the "A" corporation (owning and operating other mines in other mining districts) owned certain mining claims in the Wood River mining district of Idaho and had a long-term lease on all of the mining claims owned by two other corporations in that same district. These various mining lands, which were all adjacent and continuous to each other, had been operated by the "A" corporation for many years as one single mining operation with a separate and exclusive set of books and records just as completely kept as if it had in fact been an independent corporation.

In order to avoid disagreement over extra lateral rights, to effect a permanency of operations and to simplify their respective interests in this one natural mining operation, the three corporations decided to and did in February 1940, organize the Triumph Mining Co., and on March 15, 1940, transferred their respective assets above set forth to such corporation for all of its voting capital stock in the following proportions:

Corporation A, 38 percent.
Corporation B, 50.84 percent.
Corporation C, 11.16 percent.
Total, 100 percent.

Corporations A, B, and C continued to exist and function as separate corporations after this transfer of only a portion of their respective assets.

Thus the Triumph Mining Co., having acquired only a portion of the assets of other corporations, fails to meet the definition of an acquiring corporation and is deprived of the benefit of its base period income in computing its excess-profits tax credit, an income record which it rightfully earned and to which it should be entitled by virtue of its merely continuing the identical enterprise. It so happens that the various mining claims involved in this reorganization were acquired by the respective transferor corporations many years ago by location and assessment work and have no cost basis and the depreciable assets have been largely written off through depreciation. As a result, the entire assets of the Triumph Mining Co., although highly valuable at the time of reorganization, represent an insignificant amount of invested capital on which to compute an excess-profits credit. But a second and perhaps even greater injustice results from the effects of section 752 as it strikes this particular corporation. This section is discussed later in this presentation.

So long as the still remaining transfer or corporations involved in such reorganizations are willing to forego that portion of their own respective base period incomes which pertain to the assets transferred, it appears indefensible not to allow the resulting transferee corporation the benefit of such rightfully earned income. This amounts only to a division of a predecessor corporation's income to its own component parts.

In permitting what is defined as "acquiring corporations" the benefit of base-period net income in computing their excess-profits credit, it was clearly the intention of the Treasury Department and Congress to grant this privilege to all domestic corporations which could clearly establish such a record during their base period, and it is assumed that the same privilege was withheld from reorganizations under section 112 (b) (5) on the theory that if only a portion of the assets of a corporation or corporations was transferred, the income produced by such assets during the base period could not be definitely or equitably established. It appears to be pure oversight that the income attributable to the assets transferred was not allowed to follow the assets so transferred and the transferee corporation allowed the same choice as other corporations in electing its excess-profits credit to be determined upon the base period income allocable to the assets transferred or the invested capital represented by those same transferred assets, whichever is the greater. Such a provision would have more completely given effect to the equity contemplated in the act.

As before stated, I met with no apparent opposition in either the Treasury Department, the Bureau of Internal Revenue, or the Joint Committee on Internal Revenue Taxation in their recognition of the undeniable equity involved in this case, and was assured it was merely a matter of presentation to and consideration by Congress.

During the past month I again contacted these three agencies and once more received their unequivocal recognition of the inequity involved in disallowing to this corporation the benefit of an excess-profits credit based upon its rightfully earned base period net income. Indeed, this particular case was firmly in mind when writing the general relief provision contained in section 722 (c) (3) of the House bill.

I have been assured that such relief provision will, by correct interpretation and application, allow this corporation the benefit of its actual base period net income. Let it not be thought this corporation is unappreciative of this consideration. But that provision is quite limited in the extent of its relief and applies only to taxable years beginning after December 31, 1941, and offers no relief to this corporation for the 2 prior years.

It is evidently recognized that "acquiring corporations" generally should have full benefit of their base period experience because, in the House bill, supplement A, dealing with "acquiring corporation," it is entirely rewritten and is made retroactive.

In its new form the definition of "acquiring corporation" is again broadened to include even "substantially all the properties of a part-

nership in an exchange to which section 112 (b) (5) is or was applicable." But again this corporation is excluded from the list of recognized acquiring corporations and we must assume it is purely because it is thought that accounting problems involved in recognizing reorganizations under section 112 (b) (5) would become too involved for practical application. But there are no accounting problems in the case here presented, and this fact is also recognized.

The problem, then, is merely one of again broadening the definition of acquiring corporations so as to include those reorganizations under section 112 (b) (5) in which there are no accounting problems.

To my knowledge, the only objection to this treatment is that such cases are so few as to be unwarrantable of congressional consideration. If this be true, then all arguments are meaningless. But if inequities should be overcome when only a few taxpayers or even one taxpayer is involved, then the injustice herein described may be remedied by a simple addition to section 740 again broadening the definition of acquiring corporations in words substantially as follows, or in words which give effect to the thought herein expressed:

(5) At the option of the transferee corporation and with the written consent of the transferor corporations, a corporation which has acquired property from one or more corporations in a transaction with respect to which gain or loss was not recognized under section 112 (b) (5) of chapter 1 or a corresponding provision of a prior revenue law, provided that accounting records have been maintained which shall have clearly defined the net income attributable to such transferred assets and provided further that only the net income allocable to such transferred assets be considered in arriving at such acquiring corporation's base period net income. Base period net income so allocated to such acquiring corporation shall be deducted from the base period net income of the transferor corporations. The matter of whether or not net income is allocable to such transferred assets shall be on the basis of fact to be determined by the Commissioner of Internal Revenue.

Note how fully, in this definition, the Government is protected against any duplication of base period income to the respective component corporations and also the safeguards against dealing with complicated accounting problems. The final test of whether or not an acquiring corporation under this definition meets the requirements is left entirely with the Commissioner. As a matter of fact, the amendment as suggested could easily be made much narrower or more stringent in order to safeguard the Government against a flood of claims based upon some theoretical application of th amendment. The amendment could be made to provide that a separate and distinct set of accounting records must have been kept on the particular assets transferred to the acquiring corporation and that the respective assets thus transferred must have been operated as a complete and separate entity by one of the predecessor corporations.

Also—and this would be desirable in any event—the amendment could be made to apply only to those reorganizations effected after December 31, 1939, and before the date of the passage of the Excess Profits Tax Act.

Giving effect to these dates would close the doors to any corporations desiring hereafter to avail themselves of some advantage to be gained from some kind of split-up.

Gentlemen, this corporation is not trying to evade its just taxes or attempting in any way to ease the existing or proposed tax burden. It asks only that its taxes be computed under the same formula as applies

to other domestic corporations having a definitely established base period net income.

I intended to stop my talk at this point, but I believe you will get a much clearer picture of the double injustice of this when I explain the effects of supplement B.

Supplement B has been repealed in the House bill, but its effect still pertains to the years 1940 and 1941. That supplement, as you know, deals with what is known as highest bracket amount and allows every domestic corporation a highest bracket amount of $500,000. But in its application to acquiring corporations, this highest bracket amount and each intervening bracket is limited to an amount which bears the same ratio as the invested capital transferred bears to the total invested capital of the transferor corporation. In this case then the highest bracket amount becomes about $125,000 instead of $500,000, and each intervening bracket correspondingly reduced to about one-fourth or the first bracket reduced from $20,000 to $5,000, the second from $80,000 to $7,500, the third from $50,000 to $12,500, and so forth, and all over $125,000 at the top rate of tax.

So this corporation is not only deprived of its rightfully earned base period net income as a credit, and deprived of a credit based on invested capital, since there was no appreciable recognized invested capital, but its total income is taxed at much higher excess-profits tax rates than pertain to other corporations.

The fundamental fallacy of applying supplement B to this corporation is somewhat explained in my previous presentation from which I now desire to read. It is short:

SEC. 752. "*Highest bracket amount.*"—No objection is raised to the general theory of establishing a highest bracket amount available to corporations which undergo reorganization and thus avail themselves of a device for defeating the rates of excess-profits tax to which they would otherwise be subject without the provisions of section 752. Our objection is that this section includes corporations which were not intended to be included under the basic theory of this section. Section 752 was by its very nature intended purely as a safeguard to prevent corporations from breaking up into smaller units and thus distribute their income in such a way as to evade the rates of tax contemplated and set forth in the act.

It was clearly the intention of Congress to allow all domestic corporations existing at the time the act was introduced in Congress a highest bracket amount of $500,000, and added supplement B only as a measure for retaining such a basis thereafter. * * *

It must be admitted that section 752 and all other sections of supplement B dealing with "highest bracket amount" pertains to a condition brought about by the passage of the act itself, and were not intended to penalize or limit the acts of corporations prior to such new law. It could not, or, at least should not, have been intended to penalize acts entered into innocently prior to the time the contents of the act became public information.

The CHAIRMAN. Any questions by any member of the committee? (No response.)

The CHAIRMAN. Your main trouble is the fact that the amendments made by the House do not cover the years 1940 and 1941?

Mr. CHRISTENSEN. Yes; that is the principal objection.

The CHAIRMAN. That is the principal objection?

Mr. CHRISTENSEN. It appears rather simple to make an amendment which would and yet would not be so broad as to bring in for consideration a lot of corporations that should not have that consideration.

The CHAIRMAN. Some of the relief provisions inserted in this bill are not made retroactive. Some are.

Mr. CHRISTENSEN. Some are and some are not.

The CHAIRMAN. I have been curious to know whether the House thought it more important to give the relief now because of the increased tax rates.

Mr. CHRISTENSEN. I understand that is the principal reason for it.

The CHAIRMAN. And not so important in the years 1940 and 1941?

Mr. CHRISTENSEN. Yes.

The CHAIRMAN. Not so vital?

Mr. CHRISTENSEN. But in this case, as you probably recognize, there is a real injustice there, and a real need for that to be made retroactive.

The CHAIRMAN. Yes. Well, thank you very much.

Mr. CHRISTENSEN. I merely want to state that in connection with this supplement B which, of course, is now out of the picture since there are no brackets involved at the present time, still we were subject to it back in those years, and it would appear advisable that in the event that this one section, this relief section, is not made retroactive, or that this new broadening definition which I suggested is not introduced, then, at least, supplement B should be made retroactive insofar as it would affect corporations which were organized, already organized, prior to the time that bill was introduced in Congress.

The CHAIRMAN. Thank you very much, Mr. Christensen.

Mr. Battle.

STATEMENT OF J. D. BATTLE, WASHINGTON, D. C., EXECUTIVE SECRETARY, NATIONAL COAL ASSOCIATION

The CHAIRMAN. Mr. Battle, you are appearing here for the National Coal Association?

Mr. BATTLE. Yes; and I have a very brief statement on several subjects that I wish to present to you just as briefly as I can.

The CHAIRMAN. Yes, sir.

Mr. BATTLE. My name is J. D. Battle. I am executive secretary of the National Coal Association, the national-trade association of bituminous coal producers. Membership of the National Coal Association embraces large and small operators throughout the Nation; in fact, in every coal-producing State in the country. Membership in the association is confined to bituminous-coal producers, but in this particular instance on some of these subjects our anthracite friends are in exactly the same position as we are.

The bituminous-coal industry appreciates the present necessity for a tax bill which will produce revenue in unprecedented amounts. We realize the war cannot be waged and won without funds with which to purchase services and materials. But in the final analysis, money is only the means to an end or goal. That goal today is that we place war weapons in the hands of our armed forces to the very limit of our ability.

The coal industry of this country is exerting itself to the utmost to meet the needs of the country. In order to do so it must be allowed to keep itself in a position to function.

We are producing on an average of about 11,000,000 tons a week. We are under a rather heavy strain because of other fuel shortages

throughout the Nation, particularly in the East, and we are, to use a common expression, driving these properties pretty hard.

It is difficult to get material and supplies. Costs are going up, and the labor problem is becoming one of very serious moment.

Senator GUFFEY. Does that 11,000,000 tons include anthracite?

Mr. BATTLE. No, sir. It is just bituminous.

First I will address myself very briefly to the percentage depletion. The National Coal Association strongly urges acceptance by the Senate of section 131 of H. R. 7378 just as it passed the House. Section 131 begins on page 75 of the bill. It deals with percentage depletion for coal, fluospar, and metal mines and sulfur. This section of the bill is dealt with in the House report at page 92.

While the section I am discussing is not confined to coal, I may say that my interest in the subject is limited to coal.

The position of the bituminous-coal mining industry on the subject of percentage depletion for coal mines, and reasons for that position, were set forth very definitely in our statement before the House Ways and Means Committee. That statement appears beginning at page 1210, volume 1, of the printed report of the hearings on revenue revision of 1942.

I won't repeat it here. I am sure you gentlemen have it all before you. We do not want to burden the committee with testimony in addition to this statement, and the evidence being presented to you by other witnesses who will follow me at some later time on other phases of this subject affecting coal and other mining industries.

Senator TAFT. Have you had percentage depletion for coal before, or is this new?

Mr. BATTLE. We have had it since 1932, I think.

Senator TAFT. Has it been 5 percent all the time?

Mr. BATTLE. All the time.

Senator TAFT. So as to this provision in here, why was it put in; just to add fluospar?

Mr. BATTLE. That is all, and the suggestion from the Treasury that the percentage depletion either be eliminated or reduced all along the line.

Senator TAFT. I wondered why it was put in the bill now.

Mr. BATTLE. Just to rewrite it and put in fluorspar.

However, we do invite your attention to Mr. Paul's statement at the bottom of page 2988 and top of page 2989, of the Ways and Means Committee hearings, to the effect that approximately 75 percent of the total increase in revenue which will result from elimination of percentage depletion will come from oil and gas and only 25 percent from sulfur, metal, and coal mines. Coal is the lowest on the list. Five percent of the gross, limited to 50 percent of the net.

Obviously, then, coal is saving what might seem to be very little money by this method. However, even if it is only several million dollars—a figure not worth 2 minutes' discussion in connection with a tax measure running into the billions—this amount means much to the coal industry, which has a net deficit of more than $100,000,000 for the past 12 years.

Elimination of percentage depletion for coal mines will injure the productive well-being of the industry and the Nation out of all proportion to the insignificant revenue that may result if the method is discontinued.

All we ask of your committee is that you accept section 131 as passed by the House.

The next subject is on fiscal-year taxpayers.

The coal industry is opposed to the proposal to change treatment of fiscal-year taxpayers, as expressed in section 129, page 70, of the bill as it passed the House. This proposal would add materially to the clerical and accounting work of the companies which keep their books on a fiscal-year basis. Any advantage presently accruing to a fiscal-year taxpayer, due to the lag, would be automatically wiped out when the tax rates are lowered, as we hope and trust they will be in the not-too-distant future.

There is nothing sacred about the calendar year so far as the coal industry is concerned. As a matter of fact, the calendar year is an unnatural year for the industry. We have in the industry what is known as the coal year, and that begins on April 1 and ends on March 31. The union contracts are made on that basis, and the industry is geared to this time cycle in other ways. Some coal companies have fiscal years other than the so-called coal year.

Also many companies have made commitments, set up reserves, and advised their stockholders on the basis of fiscal-year accounting tax liability. We are sure your committee is cognizant of the many difficulties, from a business standpoint, implicit in this proposal. It should be rejected.

We believe the corporation-tax rates contained in the bill as it passed the House are so high that they will be immediately repressive upon the bituminous-coal industry.

The Secretary of the Treasury has recommended relief from the House-approved excess-profits-tax rate. We hope that the committee may find it possible to suggest a lower rate than proposed by the Treasury.

As applied to coal mining, we feel that the 45-percent normal and surtax corporate tax is too high. Secretary Morgenthau expressed the unsoundness of a 45-percent normal and surtax tax when he said before the House Ways and Means Committee—and I think he must have been thinking about the coal industry—

> A substantial share of the increased corporation tax should fall on excess profits * * *. A tax which absorbs excess profits still leaves the corporate taxpayer with sufficient margin of income for dividends and safety. On the other hand, a tax which dips too deeply into the income of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence.

Senator TAFT. He wanted 55, not 45.

Mr. BATTLE. You say he wanted 55?

Senator TAFT. Yes. I don't think you would hold him in favor of reducing it 45 percent.

Mr. BATTLE. We would like to have it not more than 40.

I am sure all of you are acquainted with the financial plight of the bituminous coal industry over the past 20 years. That condition led to an attempt on the part of Congress to stabilize the industry through the medium of legislation, thus bringing the coal industry more or less into the public-utility class.

If we are now to embark upon a program of excessive taxation, it precludes any possibility of rehabilitation within the industry. That "margin of income for * * * safety" to which Secretary Morgen-

thau referred certainly cannot be developed in a year of loss. It can be developed only in years of income; and if the income is to be siphoned off during years of income, how can the safe margin ever be acquired?

Compared with corporations engaged in other businesses, coal corporations are poor earners. The National City Bank of New York studies income records of leading corporations in principal industries. These studies are published periodically. The last one to appear covered the first quarter of 1942. It showed that the coal mining corporations reporting had a net income for the first quarter of $1,294,000. Net worth of the corporations studied as of January 1, 1942, was $168,516,000. This gives a return at an annual rate of 3.1 percent, lowest by far of the 22 industrial groups studied. The next lowest rate was 5.8 percent, and the range runs as high as 16.7 percent. The metal mining rate was reported as 7.7 percent; miscellaneous mining and quarrying, 11.9 percent; total for the entire study of 22 industrial groups, 9 percent.

We were at the foot of the list.

Extension of the consolidated returns privilege to affiliated corporations for purposes of normal and surtaxes, as provided in section 142, page 102, is unquestionably advisable. The 2-percent penalty, however, seems unwarranted. As the proposal is drawn with the penalty included, the appellation "privilege," in connection with this provision, does not seem entirely appropriate.

We hope the Senate will follow the Treasury proposal before the House committee to the effect that the capital-stock tax and declared value excess-profits tax be repealed in toto. Certainly, if you retain this item, we hope by all means that the Senate will retain the amendment in the House approved bill making provision for annual redeclaration of capital-stock value.

Section 621 of the bill as it passed the House, page 317, contains a provision imposing an excise tax on transportation of property. The proposed tax on coal is 5 cents per ton.

The Treasury Department has voiced its opposition to this proposal. We heartily endorse the conclusion of the Treasury Department that this provision should be eliminated.

We find objections to this proposal in addition to those brought forward by the Treasury Department. I am talking solely about coal. Of course, the Treasury Department was talking about the whole proposition. There are certain features in connection with it that I want to call attention to.

Now, some coal companies—many coal companies, both antlracite and bituminous—employ a central breaking system, which requires a preliminary transportation of the unprepared coal from the mine to a central preparation plant for further processing. Public transportation systems are often used for this haul, the freight rate for which ranges from 7 cents to 10 cents per ton, making the proposed tax from 50 to 70 percent of the carrier charge.

Also it must be remembered that unprepared coal is somewhat heavier than finished coal, from which the waste materials have been removed. I am told, in many instances the recovery is not more than 60 percent when you get into the preparation plant and take

out the slate and all the rock and things that go with it. Then you have got about 60 percent of good coal to ship.

Senator DANAHER. Does that apply to bituminous as well as anthracite?

Mr. BATTLE. In many instances; yes. Particularly in the stripping operations where it is stripped with a shovel and hauled to the plant. It is not marketable in that condition. It has got to be cleaned and washed and broken up. In those instances, for this reason, those companies using public transportation to take this coal from the mine to the preparation plant would be penalized as against those not forced to follow this practice.

A somewhat related problem is presented in the case of a person owning a coal mine and coke plant and using public transportation to get the coal to the coke plant.

Manifestly it would be unfair to tax the coal going from the mine to the mine's preparation plant and manifestly it would be unfair to tax the coal going to the coke plant and then, in addition, tax the coke haul. We would have a double taxation on virtually the same product after it had been processed.

For all of these many objections which have been raised against this provision, we sincerely trust the proposal will not be in the final draft of the bill. However, if section 621 is retained, we urge two amendments to take care of this situation:

(1) On page 317 of the bill as it passed the House, line 21, after the word "coal" insert the following, "coke, and briquettes."

Now, obviously those are made from coal, and in order to avoid a double taxation up to this preparation plant and then tax again on the other produce, we ask that "coke and briquettes" be added in that line.

Then, in lieu of the last sentence of the proposed subsection 3475 (a) insert the following, and I have drafted an amendment which I think will clarify that situation if the committee adopts the legislation:

The tax on the transportation of loal, coke, and briquettes shall not apply to the transportation of coal, coke, and briquettes with respect to which there has been a previous taxable transportation; nor to the transportation of unprepared coal from mines, stripping operations, or culm, slush, or refuse banks to preparation plants for cleaning, crushing, breaking, sizing, or other processing, nor to the transportation of coal to a coking or briquetting plant for manufacture into coke or briquettes provided the products thereof are reshipped in subsequent taxable transportation.

Now, that doesn't exempt any tax except avoid a double tax where this product is gathered and brought to a preparation plant or processing plant, maybe 5 miles, maybe 10 miles, maybe a little further. It is either to be taxed on—if it moves out, it will be taxed when it moves out. If it isn't moved out, I think the wording of that language would cause it to be taxed on the short haul, so it would not avoid paying its share of taxes.

Senator TAFT. Why do you want the tax on the second part of the trip instead of the first part?

Mr. BATTLE. That is the proviso. If it doesn't move out of that plant, preparation plant, if for some reason it doesn't move out, happened to be used locally, then it would be taxed on the first part. I have tried to word it so that would be done.

Senator TAFT. The way it is here, it is taxed on the first part but not on the second part. What is the reason for that? Bigger tonnage on the first part?

Mr. BATTLE. A lot of this waste material; much to be thrown out. It is not marketable goods. Then, for instance, a coke plant. I have one in mind that is 5 miles from the producing point at about 7 or 8 cents a ton freight rate. When you processed that there would be a tax on the coal up to the plant, when you processed it you would have another product and you would put a tax on it, and that would be a double taxation, really, on coal. That is really what it would amount to.

One more subject, Mr. Chairman, and I will be through.

Senator DANAHER. Before you get onto the new subject: What is there new in this subchapter E from existing law, section 3475?

Mr. BATTLE. There is no law today on the subject.

Senator DANAHER. Well, wouldn't we meet all your objections if we took it out entirely?

Mr. BATTLE. Oh, yes. Take the whole thing out; throw it all out; yes. That was my first suggestion, but if it is adopted, I would like to see it straightened out. Oh, take it all out, by all means.

Collection of income tax at the source.—The coal industry is opposed to the provision continued in the bill as it passed the House providing for collection of individual income taxes at the source. This provision begins on page 158 and ends on page 181. This provision will place additional burdens on all employers, particularly employers of many workers, such as the bituminous-coal industry. The measure provides specific rules in minute detail for withholding the tax at the source. The so-called withholding deduction is determined by the employee's marital and dependency status. For an industry already harassed by elaborate form-filing and record-keeping requirements of numerous Government agencies, this additional proposal seems to us to transcend all reason, particularly in view of the small amount of additional revenue which will be collected by the system.

In addition to the objections which employers see to this provision, the coal industry has objections somewhat peculiar to itself. For instance, in determining the withholding exemptions for an employee, how will deductions such as union check-off, checkweighmen's pay, and occupational charges be treated? And there are dozens of them around the coal mine.

We are sure that if the members of this committee and the Treasury officials themselves understood the difficulties implicit in this proposal, it would be discarded.

Sometimes there are as many as a dozen deductions. House rents are a matter of contract that is deducted. Doctors' bills are a matter of contract; that is deducted, and various other things. I just don't know how it could be handled.

Moreover, this proposal is highly discriminatory to an industry like the coal industry, the bulk of the receipts of which go to labor.

Senator BROWN. I really don't see why, if the doctor's bill and house rents are deducted from the bill they should be added. Any other man has to pay his house rent and his doctor's bills out of his general treasury.

Mr. BATTLE. It is just adding onto this great burden.

Senator BROWN. I really can't see those objections. It is a simple matter to work out.

Senator GUFFEY. The bituminous-coal industry has been profitable the last 2 or 3 years.

Mr. BATTLE. Well, it is beginning to look up—let's put it that way.

Senator GUFFEY. Haven't you been out of the red for 2 or 3 years?

Mr. BATTLE. Not 2 or 3 years. I think we have, as a whole, probably got out of the red last year, on the whole.

Senator GUFFEY. How about your company that you represent?

Mr. BATTLE. I represent practically all of them.

Senator GUFFEY. Most of them have been out of the red for 2 or 3 years.

Mr. BATTLE. I will have to disagree with you.

Senator GUFFEY. The figures don't justify your statement there.

Mr. BATTLE. I think you will find that on the whole——

Senator GUFFEY. We would be glad to have the figures if you have them. We won't go into it now.

Mr. BATTLE. We can dig them up for you all right.

According to figures just released by the Bituminous Coal Division of the Department of the Interior, total value of bituminous coal produced in the United States during 1940 was $880,000,000; but, and this is very important in considering the impact of a regulation predicated on a per-employee concept, the coal industry in 1940 had more than 439,000 employees. No other industry in America with gross receipts of approximately $1,000,000,000 employs anything like as many men as the bituminous-coal industry.

That the burden of administering the withholding tax will fall particularly hard upon the coal industry is obvious when we compare it with other industries having gross receipts approximating those of the bituminous coal-mining industry. The following statistics are taken from the Commerce Department's Census of Manufactures and cover the year 1939, the latest year for which the information is available. It is interesting to note this:

Industry	Value of products	Wage earners
Chemicals	$839,760,366	50,268
Cigarettes	1,037,747,517	27,426
Cotton broad woven goods	869,364,285	312,249
Newspaper publishing and printing	898,225,000	96,991
Paper and paper board mills	933,015,664	110,575
Primary smelting and refining of nonferrous metals	956,572,486	27,630

The above table includes all industries shown in the Commerce Department report having products valued at more than $800,000,000 and less than $1,100,000,000. Comparing the above industry figures with bituminous coal's 439,000 wage earners gives a clear picture of the disproportionate burden which will be thrown on the already overburdened records department of the coal industry.

We submit that for the more than 400,000 employees of the bituminous coal industry, the withholding tax proposal presents complex problems of considerable magnitude.

That is all, Mr. Chairman, unless there are some questions.

The CHAIRMAN. Any questions by any member of the committee?

Senator DAVIS. The production of coal at the present time is sufficient to guarantee that there will be no shortage this year?

Mr. BATTLE. If we can just hold our own, it is running at a rate that will take care of the demand. We are having great difficulty in holding our labor. You know the draft, the coal miners are very patriotic, they volunteer and the draft takes them.

Senator DAVIS. Barring all difficulties, accidents, and so forth, you have sufficient production now to satisfy the market for it?

Mr. BATTLE. Put it this way: We have a productive capacity in excess of our needs. However, we are running at about 11,000,000—

Senator DAVIS. How much coal is there now above the ground?

Mr. BATTLE. 73,000,000 plus tons in stock——

Senator DAVIS. That is a pretty good pile of coal, isn't it?

Mr. BATTLE. As of July 1.

Senator DAVIS. Would this 60,000,000 tons that they are producing in the anthracite fields be sufficient to fill the supply even now with the change from oil to coal?

Mr. BATTLE. I think it will, Senator, plus the heavy increase in bituminous production. We produced 568,000,000 tons of coal during the last 6 months of last year and the first 6 months of this year. We are running at about that rate right now. I mean for the calendar year.

Senator DAVIS. That is at a rate of production if not greater than you produced in the last war?

Mr. BATTLE. I think we went to 579,000,000 tons one year, but at that time we did not have the oil competition that we have now nor the gas competition nor hydro power and the improvement in the use of coal has reduced it many, many million tons. Better utilization, better production, better equipment. So, barring things beyond our control, such as supplies and labor, we will meet the needs of the nation. There is no question about that.

The CHAIRMAN. All right. Thank you, sir.

Mr. Viser. Is Mr. Viser in the room? Harry S. Viser, of Dallas, Tex.

(No response.) (See p. 1306 for brief submitted by Mr. Viser.)

Mr. BATTLE. On this transportation question, may I have the privilege of having some of my colleagues file a brief with you, if they so desire?

The CHAIRMAN. Yes; you may, Mr. Battle; yes, you may.

(The following communication was submitted by Mr. Battle:)

ANTHRACITE INSTITUTE,
New York, N. Y., August 14, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Committee on Finance,
Washington, D. C.

DEAR SENATOR GEORGE: In accordance with the privilege granted Mr. John D. Battle, executive secretary, National Coal Association, when he appeared before your committee on August 4 in opposition to the proposed excise tax on the transportation of coal and other matters set forth in the Revenue Act, H. R. 7378, we herewith present the following as the position of the anthracite industry of Pennsylvania and of the Anthracite Institute, its trade association, of which I am the executive director:

PROPOSED AMENDMENT

Amend section 621 of the bill by inserting in lieu of the last sentence of the proposed subsection 3475 (a) the following:

"The tax on the transportation of coal, coke, and briquettes shall not apply to the transportation of coal, coke, and briquettes with respect to which there has been a previous taxable transportation, nor to the transportation of unprepared coal from a mine, stripping operation or clum, slush, or refuse bank to a preparation plant for cleaning, crushing, breaking, sizing, or other processing; nor to the transportation of coal to a coking or briquetting plant for the manufacture into coke or briquettes, providing the products thereof are reshipped in subsequent taxable transportation."

The House bill provides that, with respect to coal, the transportation tax shall be at the rate of 5 cents a long ton, and that it shall not apply to the transportation of coal with respect to which there has been a previous taxable transportation.

This provision was inserted in order to avoid interference, which would have resulted from a nonuniform tax burden, with conditions of competition which have been established in the coal industry. The competitive situation in the industry is based on differentials in freight rates from various coal fields to given destinations, which have been built up over long years of experience, many of them as a result of rate decisions handed down by the Interstate Commerce Commission after full hearing.

A tax based on a percentage of the freight rate (or applicable to successive shipments of the same coal) would disturb competitive relationships in the industry, since coal shipped under a higher freight rate (or reshipped) would bear a higher tax, thus widening the transportation differential. The single tax at the flat rate of 5 cents a ton would preserve the net differences in freight rates.

The proposed amendment is necessary to achieve the noninterference with competitive conditions which the Ways and Means Committee of the House sought to achieve by providing a specific impost of 5 cents a long ton rather than an excise tax on a percentage basis. The operations of some companies require a preliminary transportation of the unprepared coal from the mines, stripping pits, or culm, slush, or refuse banks to a preparation plant, where the unprepared coal is cleaned, crushed, sized, or otherwise processed, before it is fit to use as fuel. For some of this preliminary transportation, public transportation facilities are used.

Other producers are equipped to do such processing at the mining location, or to transport the unprepared coal to the preparation plant with private facilities. The House bill would burden the former type of company with a serious competitive disadvantage in several ways:

(1) By custom in the industry, anthracite is sold by the producers free on board cars at the mines, transportation charges being paid by the buyer. In the normal course of events, the transportation tax would therefore also be paid by the consignee who pays the freight charges. But the companies who rely on public transportation facilities to bring the unprepared coal to the preparation plant, would be forced to absorb the tax themselves, since the transportation from the preparation plant to the retailer or consumer would not be taxable. The tax would therefore become an addition to the cost of production. As a result, the producers in the two situations would be treated unequally.

Likewise, unequal treatment would be extended to the purchasers. The buyer of coal prepared at the mine mouth would be subjected to the 5-cent tax, while the buyer of coal prepared at a distance from the mine would escape the tax.

(2) The weight of the unprepared coal, as it is shipped to the preparation plant, is very much greater than that of the finished product, because there is, on the average, only about 60 percent of acceptable, marketable coal recovered from the raw product, the remainder being slate, rock, and other refuse. Therefore, the tax, which would be added to the production costs of the producers who use public transportation facilities for the shipment of unprepared coal, would be 8⅓ cents a long ton on the finished product, not recoverable from the buyer. Where public transportation facilities are not used for shipment of unprepared coal, the operator's costs are not increased, and the buyer pays the 5-cent excise tax. This results in different treatment to operator and purchaser obviously not intended by Congress.

(3) The hauls of unprepared coal to the preparation plants are very short. As to anthracite, the minimum rate is 7 cents a long ton and the average rate is

a trifle over 10 cents a long ton. The tax of 5 cents a long ton would therefore represent a tax of 50 to 70 percent on the transportation charges on this tonnage.

(4) In the anthracite region of Pennsylvania, the entire production of prepared coal approximates 50,000,000 short tons yearly. The movement of unprepared coal by railroad to preparation plants approximates 20,000,000 long tons yearly, which represents, at a recovery ratio of 60 percent, about 12,000,000 long tons or 13,440,000 short tons of prepared coal. Thus, the producers of this tonnage, a little more than a quarter of the total anthracite tonnage, would be burdened with an increase in their production costs of 8⅓ cents a long ton, aggregating $1,000,000 annually, while the purchasers of this coal would pay no tax. On the other hand, the remainder of the anthracite tonnage would carry no tax on the producers, but the purchasers would be taxed 5 cents a long ton.

The anthracite industry has been generally recognized as one of the country's depressed industries, having, over a number of years, consistently conducted its operations at a loss. The assessment of this excise tax, amounting to $1,000,000 per year, against the producers of a small portion of the anthracite, would therefore work a great hardship on those producers, whose prices are controlled by the Office of Price Administration, while at the same time the purchasers of the coal would be exempted from the excise tax which would be paid by the buyers of coal from other producers.

For the reasons stated, the Anthracite Institute, which embraces within its membership the producers of over 80 percent of the total anthracite tonnage, petitions the committee to adopt the amendment suggested by the National Coal Association, as printed at the commencement of this brief.

Yours very sincerely,

LOUIS C. MADEIRA, III,
Executive Director.

The CHAIRMAN. Mr. Schneider.

STATEMENT OF WILLIAM W. SCHNEIDER, SECRETARY OF THE MONSANTO CHEMICAL CO., ST. LOUIS, MO.

The CHAIRMAN. You may give your name and business connections there to the reporter.

Mr. SCHNEIDER. My name is William W. Schneider and I am the secretary of the Monsanto Chemical Co., whose principal office is in St. Louis, Mo. We own and operate chemical manufacturing plants and laboratories in Missouri, Illinois, Michigan, Ohio, New Jersey, Massachusetts, Tennessee, Alabama, Virginia, and West Virginia. We also have built and are operating several war plants at various locations for the account of the United States Government.

Our net income for 1942, before income and excess profits taxes, will be in the neighborhood of $17,000,000 or $18,000,000 and on the basis of the rates in Secretary Morgenthau's recommendations our taxes for this year will be in the neighborhood of $13,500,000 or $14,000,000.

There are a number of points in the bill passed by the House upon which we would like to comment, but for the purpose of emphasizing our objections to two points I am confining my comments to only those two points.

The first point is one to which insufficient attention has been given by other taxpayers. It has to do with the relief section No. 722. Section 722 was amended by the "Excess Profits Tax Amendments of 1941," so as to provide that any taxpayer that avails itself of the relief granted by that section must pay an additional tax equal to 10 percent of what would have been the excess-profits tax computed without the use of section 722.

The actual effect of that provision is to assess a penalty of 10 percent of the original excess-profits tax on anyone seeking to make use of that section. I am under the impression that the purpose of that 10-percent penalty clause was to discourage the submission of a multitude of small claims or nuisance claims which would require much time and trouble to audit and dispose of. However, with the very great increase in excess-profits tax rates, the amount of that penalty in dollars and cents has multiplied in amount, and it is now much more than a deterrent to small claims or nuisance claims. It is actually a bar to meritorious claims that are very substantial in amount.

Our company had several unusual situations in the 4-year base period which held down the earnings during those years. One of these involved the building and the initial operation of a plant in Tennessee to produce elemental phosphorus which was the first time that product had been produced in this country on a large scale. It took many months to iron out the "kinks" in that new operation, and the operating profits were unsatisfactory for quite some time after the plant commenced operation. We had a few other cases where profits were either abnormally low or nonexistent because of somewhat similar situations.

Under the 1940 excess-profits rates, the 10 percent penalty on our company for using section 722 would be $116,000, for 1941 the penalty would be $640,000, and for 1942 it is estimated that such penalty would be between $1,100,000 and $1,200,000. In other words, if for 1942 our relief claim under section 722 would amount to $1,200,000 or less, we would actually get no relief. It is reaching a point where the so-called relief section is a myth or a misnomer. Certainly, penalties in such big amounts are not needed to discourage the filing of numerous small claims or nuisance claims.

It is our contention that the provision for relief against hardships created by unusual situations is a necessary part of any excess-profits tax law, and must be an integral part of such law if it is to be fair and equitable in its application. Congress and the Treasury have recognized this principle. If the taxpayers are entitled to such relief as a matter of fairness and equity, then we can't understand why there should be imposed such huge penalties for making use of such relief provisions. We don't believe there is any sound reason for such a large penalty. A penalty of $10,000 or 10 percent of the relief claim, whichever is the lower, would probably accomplish the purpose of discouraging the filing of too many small claims or nuisance claims.

I don't believe any speaker touched upon this subject before the House Ways and Means Committee, although I note that in the House bill this penalty was reduced from 10 percent to 5 percent. I might add here that we did not appear before the House Ways and Means Committee because we did not have our eyes opened to that situation until after the hearings had been concluded.

The claims under the relief section are not due to be filed until September 15, which is 6 months after the filing of the tax return, and I believe very few companies had computed in June or July the actual effect of this section on their 1941 business or the 1942 business. That was possibly because most taxpayers hadn't calculated the effect

of the penalty on their 1941 business, because the returns for 1941 under the relief section are not required to be filed until next September 15. The 5 percent is still much too high. It would mean a penalty of $500,000 to $600,000 against us if we seek to use the relief section No. 722 for 1942. There should be no penalty for using a provision that is a proper necessary part of any fair and equitable excess-profits tax law.

The CHAIRMAN. What is your suggestion, Mr. Schneider?

Mr. SCHNEIDER. My suggestion is that a penalty of 10 percent of the relief claim or $10,000, whichever is the lower, would probably accomplish the purpose of discouraging the filing of numerous small nuisance claims. My point is that a penalty of $500,000 or $600,000 is unnecessary for that purpose. It is just simply a huge penalty.

The claims for relief under section 722 for 1941 taxes are not required to be filed until the 15th of next month, September 15. If it is recognized that the penalty is wrong and should be eliminated, it should also be eliminated for 1941 as well as for 1942 and hereafter, because relief claims for 1941 have not been filed and no confusion would result from making the change for 1941. We, therefore, urge the elimination of the penalty not only for 1942 but also for 1941. We also believe the other amendments to section 722 can easily be made effective for 1941 as well as for 1942.

Those other amendments have done much to clarify the law and improve the law and I don't know of any reason why they couldn't be extended to 1941. I think the Treasury has recognized from the very beginning that such provision should be in the law and the present provision in the House bill is a development and improvement over the original provisions.

The objectionable penalty provisions are in lines 24 and 25 on page 212, lines 1 to 4 and lines 10 to 14 on page 213 of the House bill.

The other point we desire to emphasize is that the combination of the rates of 45 percent normal and surtax and 90 percent excess-profits tax are too high, particularly if they are not subject to a post-war credit. With such rates in effect, there is no incentive for efficiency or progress. They simply encourage carelessness in operations and extravagance in spending. This was even true under the composite rates in effect for 1941 and it will be true to a greater degree in 1942. Many times I heard the statement made last year: "Well, what's the difference, the Government pays 72 percent of it and the company pays only 28 percent of it." The management, of course, did its best to discourage any such attitude.

Senator TAFT. It seems to me, though, that that in a way answers it. It is going to be 65 anyway, and the argument is practically made whether it is 65 or 70 percent or whether it is 90 percent. It doesn't seem to be very different.

Mr. SCHNEIDER. If it is left at 90 percent, you have a case where any company or taxpayer actually pays only 10 percent of such spending, whereas if it is less than 90 percent or 75 percent, that attitude is discouraged to that extent.

Senator TAFT. It seems to me the argument is just about as strong one way as the other. If you say: Why not spend it, the Government is going to pay 70 percent of it, or if you say: Why not spend it, the

Government is going to pay 90 percent of it. I don't see very much difference.

Mr. SCHNEIDER. The point I wish to make is that if under the law the Government takes 90 percent of all additional savings or profits and, in effect, pays 90 percent of all additional expenses, there is only slight incentive to save, or to avoid waste, or to increase efficiency. This detrimental effect of such high tax rates can be greatly counteracted by the return of a portion of such tax after the war, provided no strings are tied to the return. If the repayment is conditioned upon compliance with certain objectives, so that the repayment is not certain, it might as well be omitted, because the repayment will not be depended upon by anyone. Many corporations who have tied up their surpluses in machinery and equipment and expanded plant facilities will find that their surpluses are frozen in idle plant facilities when the war ends and Government orders are abruptly canceled. That is the time when a repayment of such tax will save many corporations from liquidating and folding up, and for that reason alone it is wise to provide for a return of a portion of such tax. England and Canada are proceeding on this basis, and we believe it would be a wise thing to do in this country. I won't elaborate further on this point, because it has been well covered by more capable persons appearing before your committee.

I wish to thank the committee and the chairman for the time they have given us at this hearing.

The CHAIRMAN. All right, Senator Clark.

Senator CLARK. In connection with that last point you make about a provision for post-war refunds. I had a letter from the president of your company some months ago in which he pointed out that the Monsanto Chemical Co. erected several plants which there is no expectation or intention of operating when the war is over—for purely war purposes—and he suggested a problem was going to be presented when those men who are employed in those plants were all laid off suddenly when the company closes its plant after the war because the company has no normal use for those plants. He suggested that his company and many other companies would be glad to set up a fund out of their earnings as a sort of severance cushion for those employees who will be severed from their employment. They can't afford to set out part of their earnings because of the 90-percent tax on it. Are you familiar with that situation?

Mr. SCHNEIDER. Yes; I saw that letter sent to the delegation from Missouri. It was to this effect: That under the present law if we set up a reserve to cover that severance pay of men whom we know will be let out when the war is over, we cannot take a deduction for that reserve for income-tax purposes. We would like to set up such a reserve on our books and become obligated to use it after the war is over for that purpose if we could deduct that as an expense of our operations. For instance, what we have in mind is that we, under a contract with the Government, are to operate a large TNT plant in Texas. That TNT plant will not operate after the war. There will be perhaps 3,000 or 4,000 employees at that plant who will be laid off when the war is over.

Senator CLARK. That you know how you will intend to lay off?

Mr. SCHNEIDER. We feel sure the Government will not want us to operate that plant when the war is over, and we would like to take care of those men, but we can't do it under present tax laws.

Senator CLARK. You are not allowed to take a deduction in computing your income?

Mr. SCHNEIDER. That is correct.

Senator CLARK. I might say I called that matter to the attention of the Treasury several times but haven't been able to get an answer.

Mr. SCHNEIDER. I have confined my remarks to two outstanding points in the House bill without trying to cover too many points. I think the two points I mentioned are very important.

The CHAIRMAN. I wish the Treasury would especially note this point that Mr. Schneider has called our attention to. If there is a relief provision, the penalty ought not to be fixed on a flat 5-percent basis.

Mr. SCHNEIDER. I believe the only purpose of the penalty is to discourage the filing of nuisance claims.

The CHAIRMAN. I think it is very well to do that, but it looks like some suggestion along the lines you made ought to be worked out that would take care of that and not penalize the companies that had a real just relief case if they were allowed to use it without that penalty.

Senator DANAHER. Mr. Schneider, if we do not disturb the penalty what one of the subclauses under section 722 do you feel covers the case that you have described to us?

Mr. SCHNEIDER. You mean the present law?

Senator DANAHER. Yes; or the pending bill.

Mr. SCHNEIDER. I suggested that on pages 212 and 213, the objectionable clauses are lines 24 and 25 on page 212, lines 1 to 3 on page 213, and lines 10 to 14 on page 213. Those are the clauses that pertain to this 5-percent penalty I speak of.

Senator CLARK. Yes; but suppose we don't disturb the penalty, where do you get your relief under section 722? Where do you get any relief for a case such as you have described?

Mr. SCHNEIDER. Well, I don't know whether I understand you. These two paragraphs are the paragraphs that have the effect of adding 5 percent to your excess-profits taxes if you seek to avail yourself of section 722. If you omit those two paragraphs, there will not be the 5 percent penalty attached to making use of that section.

Senator TAFT. Which part of section 722 do you get under? Which express relief provision does the Monsanto Chemical Co. get under?

Mr. SCHNEIDER. Particularly those two paragraphs that pertain to increases of plant capacity and to the installation of new processes. I just referred to the new plant we erected in Tennessee using an entirely new process and making a new product which took a couple of years to get under way and operating smoothly, and that was during this base-year period. We had an investment of four or five million dollars in that plant and got no return on it in those years.

Senator TAFT. I don't mean to necessarily imply the 40-percent rate, but it seems to me the argument against it is rather the need for reserve money than it is the psychological effect of getting very little benefit from economies because I think we are going to have that psychological effect anyway. We have got it already and I don't see how we can get rid of it.

Mr. SCHNEIDER. I think that is true, Senator. We are running into it all the time.

Senator TAFT. You can't get away from it. That is what I mean.

Mr. SCHNEIDER. No, we can't get away from it, but I think it can be discouraged to a certain extent by holding out the thought that after the war you can get back a part of that tax, and I think it will do a lot to cushion the situation at that time. Many corporations are going to find themselves with their surplus in frozen assets and won't be able to do anything about it.

Senator TAFT. I agree with you.

The CHAIRMAN. All right, sir. Thank you very much.

The CHAIRMAN. Mr. Brenckman.

(No response.)

The CHAIRMAN. Mr. Lawrence.

STATEMENT OF JOHN V. LAWRENCE, MANAGER, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, D. C.

The CHAIRMAN. All right. You may give your name, Mr. Lawrence, and your business connection.

Mr. LAWRENCE. My name is John V. Lawrence. I am general manager of the American Trucking Associations, Inc., with offices at 1424 Sixteenth Street NW., Washington, D. C.

The association is a federation of 50 associations in the various States, the District of Columbia, and the Territory of Hawaii. Its membership represents every type of trucking service.

Members of the affiliated associations in the States are members of the national organization, exercising their franchise through their State or local group.

May I say that we are not appearing here today merely to complain about higher taxes as such. The trucking industry is willing, ready, and anxious to pay its full share of the cost of the war program. We are appearing not to complain but rather to explain the effect of proposed excise tax increases upon the operations of our members.

We know full well that this committee deeply feels its great responsibility; that it is anxious to draft a revenue measure which will be as fair and equitable as possibly can be devised. We realize, too, that this committee cannot appreciate the effect of a given tax proposal upon every group of taxpayers, and we, therefore, see it as our duty both to this committee and to our membership to point out the essential facts which underlie the proposal to double the tax on gasoline and to increase the levy upon lubricating oil from 4½ cents to 10 cents per gallon.

Trucks originally won their place in the business world because they could haul loads more cheaply and more quickly than horse-drawn drays. As they became more reliable, as their original cost and operating costs were reduced, the radii of their service field expanded proportionately. They took over an increasing amount of less-than-carload freight and merchandise traffic, and handled it economically and efficiently. Efforts of other forms of transportation to throttle this expansion failed. Truck transportation made a place for itself as an essential arm of the national transportation system.

So accustomed have we as a nation become to efficient highway transportation that we all too frequently overlook its indispensability in such critical times as these. Yet highway transport's established record of service has earned it the right to be classed as a major national resource. Its infiltration into our whole national economy is so complete that only nonessential motor vehicle uses may be eliminated without impairment of that economy. And this is being fast accomplished under tire and gasoline rationing.

In 1941 highway truck mileage increased 15 percent, and conservative estimates at the beginning of the year by responsible governmental agencies indicate increases in traffic volume for 1942 over 1941 will be in the neighborhood of 13 percent for the movement of goods and 20 percent for the movement of persons.

A survey conducted to ascertain transport requirements of 749 Michigan defense plants revealed that some part of both incoming and outgoing freight is shipped by truck at every one of these factories. In 13 percent of the plants all incoming shipments, and in 15 percent all outgoing shipments are made by truck. In 38 percent of the defense plants studied, 90 percent of the incoming shipments are made by truck, while in 43 percent of the plants, 90 percent of the outgoing shipments were over the highways.

The study also disclosed that 1 out of every 5 of the workers in these defense plants lives more than 10 miles from the factory, and 3 out of 4 come to work by passenger automobile every day. The facts indicate that out of 850,000 wage earners in Michigan industries, 635,000 are dependent upon the private automobile.

The existing stock of motor vehicles in operation at the end of 1941 provides a measure of their over-all carrying capacity available to the war-production effort. Some 4,912,000 trucks and tractor trucks, together with approximately 277,000 commercial trailers and semitrailers provide a total instant capacity of more than 13,000,000 tons.

These illustrations are by no means unique. Surveys of the same kind in other States would disclose similar reliance upon highway transportation. Even if it were practicable for the railroads to handle some of this traffic movement, it would be impossible for them to do so because their facilities, too, are being utilized to the limit of capacity. According to statements of Director Eastman, of the Office of Defense Transportation, trucks are handling 18 percent of the traffic load.

Gentlemen, there is no substitute for highway transportation. It is essential to our war-production program. Our vast munitions industry would be useless if we failed to get them men and materials to the plants. All the large new plants were built with the thought in mind that they would be serviced by trucks, cars, and busses.

Fortunately, highway transportation has been able to develop here in the United States with reasonable freedom. Highway transportation has not been hamstrung here as much as it has been elsewhere.

In England prior to the war competitive transportation succeeded in securing passage of the Transportation Act of 1933, which provided that the number of trucks could not be increased beyond the quota then in operation. Little imagination is needed to visualize the gross stupidity of this statute. During the blitzkrieg many railroad lines were put out of action. Traffic was tied up. Trucks alone could keep mov-

ing. If one road was bombed out, an alternate route always was available. The roads were available, but the trucks were not, at least not in anything like the number needed.

Before the war the Government, at the instigation of the Australian railroads, placed all sorts of ridiculous curbs upon highway transportation. Now both the railroads and the Government are busily trying to untie the knots with which they sought to strangle motor transportation. Gentlemen, we cannot afford to repeat here the mistakes of England, of Australia.

I have tried to bring out two points:

First. The indispensability of highway transportation in all-out war.

Second. The fact that it should not be hampered through injudicial legislation.

Although these levies are intended as excises upon two essential commodities, their practical effect upon truck operators is that of a special tax upon one form of transportation. These levies, I believe—in their effect on commercial highway carriers—typify what the President had in mind when he said, in a recent Budget message:

> Tax programs too often follow the line of least resistance. The present task definitely requires enactment of a well-balanced program which takes account of revenue requirements, equity, and economic necessities.

The proposed 3-cent tax upon gasoline and the 10-cent tax upon lubricating oil is equivalent to a special and exceedingly heavy impost upon one indispensable form of transportation, while no equivalent tax is proposed for other and competitive transportation media. I submit that it would be definitely unfair to single out highway transportation unless a tax of similar weight were proposed for railroads and other transport media.

Let me clarify my point.

Senator BROWN. That 3-cent gas tax is not in the House bill.

Mr. LAWRENCE. That is true, sir. Mr. Morgenthau had proposed its inclusion in this bill.

The average retail price of gasoline this spring was slightly less than 15 cents per gallon. A 3-cent Federal tax would be the equivalent of a 20-percent retail sales tax on a necessity. This is certainly disproportionate, but it must be borne in mind that the States already tax gasoline at rates ranging from 2 to 7 cents a gallon. In my testimony before the House committee in hearings on the 1941 act I pointed out at page 123 of hearing record that the tax on gasoline was then 100 percent of its value. A 1-cent increase in tax would increase this by 16⅔ percent additional. A 1½-cent tax would mean an additional 25 percent of its value.

The proposal to tax lubricating oil 10 cents per gallon is likewise disproportionate, when it is realized that lubricants range in price from 30 cents to $1 a gallon.

Senator BROWN. Again, there, the House didn't put in 10 cents; they put in 6 on lubricating oil.

Mr. LAWRENCE. That is true, but the Treasury proposal was to increase from 4½ to 10.

The CHAIRMAN. The committee has had a good many requests for a tax on reclaimed lubricating oil. Do you know anything about that?

Mr. LAWRENCE. I presume, sir, in recent years that has become an important angle. A lot of reclaiming done, and that may be a competitive angle.

The CHAIRMAN. I suppose it must be.

Mr. LAWRENCE. The simple average State and Federal gasoline tax now amounts to 5.97 cents per gallon. If it is increased by 1½ cents, as proposed, a total levy will amount to practically 7½ cents. Even the smallest trucks do not average 15 miles per gallon and they would pay more than one-half cent per mile in taxes. Medium-size trucks traveling 10 miles per gallon would pay three-fourths of a cent per mile. Thousands of trucks travel less than 7½ miles per gallon, so that their levy would average a cent per mile or better. Large trucks, averaging only 3 miles per gallon, would pay 2½ cents per mile in gasoline taxes alone. One cent of this amount would be paid to the Federal Government, the balance to the State, and this, of course, in addition to heavy registration fees, and in some cases, mileage taxes levied by the States. I indicated to this committee last year that the average annual tax on an over-the-road truck in this territory at 1 cent per gallon would be $190 per truck per year, that for one particular company it would be $270 per truck per year. At 1½ cents, the increased tax would be $285 and $405 per truck, respectively.

The point, I hope, is clear. If this tax increase is enacted, one branch of transportation will be forced to pay a heavy mileage tax for the purpose of financing the general functions of the Federal Government, while all other forms of transportation will escape this or an equivalent levy.

I might point out that next to labor, which takes about 50 cents of every dollar, that truck operation takes in the next highest expense its fuel cost.

Recently we have seen in the press a suggestion that the excise tax on gasoline be increased to repay the Reconstruction Finance Corporation the cost of absorbing the 2½ cents increase in gasoline prices allowed in the eastern rationing area. Last year the Petroleum Coordinator urged a committee of Congress, as well as the Office of Production Management, to provide materials for the construction of pipe lines to this east-coast area. These requests to the authorities in charge of material were turned down. Today we do not have the pipe lines. The railroads are doing a splendid job in hauling gasoline to this area, but it must not be forgotten that they were the chief sources of opposition to the proposed pipe line.

Hindsight is always better than foresight, but the foresight shown at that time by the Petroleum Coordinator was not heeded and acted upon. We, therefore, feel that it would not be fair to tax those who find themselves in a rationed gasoline area through no fault of their own.

If any equalizing tax of this type was put into effect—and I say "if"—the 1½ cents suggested is far too high. In 1941 of 24,366,267,000 gallons of gasoline consumed by motor vehicles in this country, 8,946,389,000 gallons were consumed in the eastern rationing area, or 32.61 percent of the country's total. If an excise tax were to be levied to make up the 2½ cents per gallon in the rationing area, this would

mean that 0.0082 would be ample countrywise if the eastern demand remained the same as last year. With rationing, however—and the final figures won't be available for some time—consumption will drop materially and the likely figure would be close to one-half.

Since January of 1941 gasoline prices have increased materially in these Eastern Seaboard States, in the New York and New England area, to an amount of practically 100 percent, including the 2½ cents increase. We believe that before any compensating tax was levied, that a thorough examination be made of this question to determine whether increased transportation costs had not been taken care of to a large extent, even before the 2½ cents increase in the price ceiling was allowed. Here are some of the examples: I take 6 of the 16 States:

Massachusetts.—Total price increase between January 1941, and June 1942, 0.06 cents per gallon.

That is based on the shipside price at Boston and the shipside price was 5.1, so it is slightly over 5 cents increase.

Pennsylvania.—Total price increase between January 1941 and June 1942, 0.057 cents per gallon.

New Jersey.—Total price increase between January 1941 and July 1942, 0.057 cents per gallon.

Senator JOHNSON. These are retail prices or wholesale prices?

Mr. LAWRENCE. They are mostly wholesale without the tax included. This is the price added together.

Georgia.—Total price increase between January 1941 and June 1942, 0.064 cents per gallon.

North Carolina.—Total price increase between April 1941 and June 1942, 0.047 cents per gallon.

New York State, including New York City.—Total price increase between January 1941 and July 1942, 0.078 cents per gallon.

That in all classes includes the 2½ cents to be removed.

We, therefore, submit that it would be quite unfair to levy on gasoline users, and particularly on truck transportation, a compensating tax of the nature proposed.

Let me summarize the objections which the American trucking industry makes to an increased tax on motor fuel:

1. Gasoline is not a luxury and should not bear a special Federal sales tax of 20 percent, for it is already taxed at rates ranging from 15 to 60 percent by the various States.

2. Gasoline already is being rationed and will be rationed more severely in the immediate future. Therefore, a high tax is not needed to curb inflation. On the contrary, limitations placed upon nonessential driving through tire rationing and discontinuance of automobile building will so reduce consumption that the trend of gasoline prices will probably be downward rather than upward.

3. Because every commodity is transported by truck in some stage of its journey, from producer or processor to consumer, an increase in the Federal tax would cause a corresponding increase in the price of every commodity.

4. The proposed increase is inequitable and discriminatory because it applies only to one form of transportation, while no comparable levy is proposed for other transportation media.

5. Consumption of gasoline will decline progressively month by month as vehicles and tires wear out. This loss of revenue will deal a body blow to the States which rely upon it for financing highways.

I might point out there that I notice in the press the Public Roads Administration in their latest estimates had indicated a drop of 17 percent in gasoline-tax collections in the States. It is unreasonable and unjust for the Federal Government further to invade this rapidly shrinking field of taxation when it has many alternate sources of revenue—the States so few.

6. Simply because the gasoline tax has been a prolific and equitable revenue producer for the States in normal times, it does not follow that it is a desirable or productive tax source for the Federal Government in abnormal times.

The CHAIRMAN. Any questions?

Senator CONNALLY. May I ask a question?

The CHAIRMAN. Yes, Senator Connally.

Senator CONNALLY. What do you have to say to the claim in the case of trucks especially that they are not paying now in license and other taxes anything at all commensurate with the use that they get, the free use of the public highways, which is financed at public expense? Just off the tax on gasoline, they wouldn't pay anything like what they would the roads?

Mr. LAWRENCE. Well, all we ask is not to increase it further.

Senator CONNALLY. Just leaving it as it is, would they still pay, do you think?

Mr. LAWRENCE. The only unbiased study thus far made, except one under process by the National Board of Investigation and Research which the Congress set up in the act of 1940, was made by the Federal Coordinator of Transportation, Mr. Joseph B. Eastman, and in that survey, known as Public Aids to Transportation, four volumes, Mr. Eastman found that there were overpayments rather than underpayments, and the larger tru ks were overpaying to the greatest extent, up to $287 per year. I know the question has been carried in the press and the accusation made, but the only unbiased study that I know of made by Mr. Eastman showed that that was not the case, sir.

Senator TAFT. Is it true that the Federal Government takes in a good deal more money in this case than they pay out for highways?

Mr. LAWRENCE. It was interesting to note that, Senator Taft, in that study of Mr. Eastman's, they charged the highway user with the Federal-aid payment and other Federal disbursements to the State, but they did not credit the motor-vehicle user with the excise tax levied by the Congress, and I think if we go back to the last war and average them all up, not only gasoline tax, but when you take in the excise tax on lubricating oil, automotive parts, and vehicles, that it is substantially more than the Federal-aid payments voted by the Congress, by several hundred million dollars.

The CHAIRMAN. Are there any further questions?

Senator CONNALLY. You said no other transportation paid any tax. Don't the railroads pay fuel taxes?

Mr. LAWRENCE. No fuel taxes that I know of.

Senator CONNALLY. On fuel oil?

Mr. LAWRENCE. Not that I know of, sir.

Senator CONNALLY. I am sure fuel oil has a small tax. I don't know what it is.

Mr. LAWRENCE. We all pay the ordinary corporate taxes. We are worried about your excess-profits tax, if we make any money, and various other things, but we all pay those taxes. This is a special tax that I am speaking of, and I don't know of any other transport media that pays it.

Senator CONNALLY. Everybody that rides in an automobile pays it, and that is everybody.

Mr. LAWRENCE. That is true.

Senator CONNALLY. You are in it for revenue and the rest of us are in it just because we have to ride back and forth to our offices. You are making money out of it.

Mr. LAWRENCE. Some of them are trying to. They haven't been doing much lately, Senator.

The CHAIRMAN. Well, thank you very much, Mr. Lawrence.

Mr. LAWRENCE. Thank you, sir.

The CHAIRMAN. Did Mr. C. V. Anderson come into the room?

(No response.)

The CHAIRMAN. Mr. Harry Viser?

(No response.)

The CHAIRMAN. They are witnesses that were on today.

Mr. Fred Brenckman. I believe he is not in the room.

That completes the list of witnesses today. We will recess until 10 o'clock tomorrow morning.

(Whereupon, at 3:30 p. m., the committee adjourned until 10 a. m., August 5, 1942.)

REVENUE ACT OF 1942

WEDNESDAY, AUGUST 5, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312 Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order.

Mr. Iglauer.

STATEMENT OF JAY IGLAUER, CLEVELAND, OHIO, REPRESENTING THE NATIONAL RETAIL DRY GOODS ASSOCIATION

Mr. IGLAUER. My name is Jay Iglauer. I represent the tax committee of the National Retail Dry Goods Association. The organization has been in existence for more than 30 years and represents more than 6,000 department and specialty stores located in every State in the Union.

In the interest of brevity, I confine myself to five subjects: Economy in nonwar expenditures, war retail-sales tax, corporate normal and surtax, excess-profits taxes, and an amendment to the Internal Revenue Code respecting estate and inheritance taxes. My prepared statement will consume not more than 12 minutes.

Economy in nonwar expenditures.—The expenditures for the war effort which have reached astronomical proportions, impel us to renew our plea to you, as Members of the Senate, to bend every effort to reduce nonwar expenditures. The willingness of the people generally to accept the heavy burdens of taxation, and their wholehearted support of the administration's program for war, as indicated in the various public-opinion polls, is remarkable and encouraging.

You can contribute materially to the preservation of that morale by compelling a reduction of the burden, upon the Government and upon the people of those expenditures that are now not essential to victory. We are apprehensive that unless nonwar expenditures are cut drastically, the public will put the responsibility upon Congress and the administration, for the impairment of public morale which will surely follow unless these expenditures are cut to the bone.

The bill before you is still short of the goal set by the Treasury by some 2½ billions of dollars, in spite of the fact that the rates of tax upon business are such as to raise serious doubts concerning the survival of the average small business. It is perhaps a coincidence that this deficiency is almost exactly the amount of the revenue yield of a

5-percent retail-sales tax as estimated by the experts of the Joint Committee on Internal Revenue Taxation.

Retailers generally have always opposed consumption taxes in ordinary times. It makes their task of selling goods more difficult. Now, in wartime, we welcome the opportunity to help with the war effort by assuming heavy burdens of expense and administration in connection with priorities, scarcities, transportation, price control, and taxation.

War retail sales tax.—In proposing a war retail sales tax, the National Retail Dry Goods Association did not lightly arrive at this conclusion. Early this year a referendum of our membership was taken on the subject of retail sales taxes as compared with manufacturers' excise taxes. Out of 60 percent of all the members of the association who responded to this referendum, 78 percent favored a general retail sales tax in the present emergency. Doubtless you are aware that a 60-percent return on a questionnaire of this type is phenomenal.

We propose the adoption of a war retail sales tax of 5 percent of the purchase price of all tangible personal property to be paid by the consumer at the time of the purchase. It should apply to all sorts of tangible personal property, much of which may not commonly be sold through retail stores. In addition to everything ordinarily known as consumer goods, it should apply to all purchases of machinery, fixtures, supplies, factory and store equipment, and so forth; exempting only the purchase of such items as are required for the production of war materials. The tax should not apply to personal or professional services, such as those of physicians, dentists, attorneys, or to salaries and wages, or to rents or to the cost of insurance.

This recommendation contemplates the repeal of the manufacturers' excise taxes except those on tobacco, liquor, gasoline, and oil, and the repeal of the retail excise taxes on furs, jewelry, and toilet goods.

Senator BROWN. Mr. Iglauer, if we are going to have a general retail sales tax, I think consideration should be given to including personal services as well as sales of goods.

When Michigan enacted its retail sales tax, which has been very successful, I think we raised about 80 or 90 million dollars a year on it, the Governor, basing his recommendation upon a study made by experts at the University of Michigan, proposed to include services of doctors, dentists, lawyers, so on and so forth.

Most everybody in the State seemed to think it was a much better and more logical tax than merely a tax on retail sales. The legislature rejected the idea, but I gathered the impression at the time, and have had it ever since, that if you are going to have a general sales tax, it should include personal services.

I would like to know why you reject that in your statement.

Mr. IGLAUER. I have no objection, only the problems of administration and collection.

Senator BROWN. I see. I just wanted to interpose to say that I know it was the viewpoint of the experts of the Governors' Commission at that time, in 1933, that personal services should be included in any general sales tax program.

Mr. IGLAUER. That would materially increase the yield.

Senator BROWN. It certainly would.

Mr. IGLAUER. We recognize what this means to the consumer and we therefore ask that you put a definite limit on the life and application of the tax we propose, by providing that the war retail sales tax shall cease 6 months after the end of the war.

A war retail sales tax has the following advantages:

1. It will in no way interfere with or complicate the problem of the Price Administrator, since it will apply cleanly and in addition to the prices authorized by the Administrator. All other taxes which apply at other steps in the economic process—such as manufacturers' taxes, tend to increase costs at the point of application and at all subsequent steps.

2. The effect of the war retail sales tax is distinctly deflationary. It will syphon off considerable excess purchasing power. Economists generally agree that this is an important element in preventing inflation.

Senator VANDENBERG. Of course you disagree at that point with the Treasury's suggestion that a sales tax is inflationary.

Mr. IGLAUER. Yes; I do.

Senator VANDENBERG. I entirely agree with your disagreement.

Mr. IGLAUER. I think we could prove our point next year more nearly than we can this year.

Senator VANDENBERG. I think it is absurd to say a fixed governmental assessment against a given commodity is inflationary.

Mr. IGLAUER. That is right.

3. When the time comes for the repeal of the tax, it will leave no tax content in inventories, which means an immediate reduction in costs to the ultimate consumer.

Senator VANDENBERG. I do not quite see where you are going to repeal taxes 6 months after the end of the war. We will just begin to be in financial trouble at that time.

Mr. IGLAUER. Nobody knows when we will get into the financial trouble you are talking about. It might be 6 months after the war. It might be a year and a half after the war.

4. In this period of great national emergency, it is necessary to get some revenue from all earners of income. About 28½ percent of our national income is earned by people receiving incomes of less than $2,000 a year. Under our income-tax system comparatively few of those people pay any income tax.

In view of the great national emergency, it seems equitable and advisable to spread the base to everybody earning income. Small amounts in the form of a war retail sales tax secured from this group earning 28½ percent of our national income would not work a hardship on them and at the same time, would produce considerable revenue.

It will derive revenue from over 13,000,000 gainfully employed who cannot be reached through the withholding provision of the bill or through any other form of tax except a sales tax.

Actually that number in the 1940 census, is something like 17,000,000 but I have stated it conservatively, because there might be some among the census group who might be in the income-tax groups.

5. When you are considering the question of the extremely low income-tax exemptions provided in the proposed bill, remember that it is far easier to collect such war retail sales taxes from the lower

income groups than to collect income tax through the lowering of exemptions. There would be far less resentment when the tax comes in small doses on each purchase than in the comparatively large amounts which become apparent when the income-tax blank is being filled out. It is obvious that the policing and administration of the vast number of income-tax returns of small amounts by the Bureau of Internal Revenue is a well-nigh impossible task.

6. There has been evident hesitation upon the part of Congress to impose consumption taxes upon the people of the lower-income group. I submit that one of the important purposes of the war retail sales tax will be to prevent inflation. If inflation be allowed to pursue its natural course, all persons in the lower-income brackets would suffer far more severely than they would in paying a 5-percent war retail-sales tax. If, by the device of the war retail-sales tax and the other measures the Government has already taken, you can protect those in the lower-income brackets from the effects of inflation, you will have done them an inestimable service.

Now, in presenting this part of the report, I have been asked by the American Retail Federation, in order to save a separate presentation by them and to conserve your time, to state that they concur in this recommendation. Mr. Puckett appeared before the House Ways and Means Committee in favor of a 5-percent retail sales tax, and that organization represents 13 national organizations and 28 State retail associations with approximately 400,000 retail merchants in its membership.

Senator TAFT. Mr. Iglauer, you do not recommend the exemption of food or any other commodity?

Mr. IGLAUER. No; I do not. It does not seem justifiable, if during peacetime we put a tax on food, to subsidize a part of our population that we would fail to do it now in wartime. I am referring to the processing taxes and the subsidy to agriculture.

Corporate normal and surtax.—In presenting our views concerning income taxes on corporations, we ask you to remember that a large number of corporations are not engaged in war activities and that many of these are represented in our membership. Under conditions that appear to be facing us in the latter part of 1942 and 1943, and as long as the war lasts, the problem of survival is of paramount importance, not only to us but to the whole economy.

It is conceivable that even the most efficient of those not engaged in war activities will suffer substantial reduction in their volume of sales, and in their operating profits. Theirs is not so much a problem of reconversion to peacetime activities to which you have given much consideration in your deliberations but of rehabilitation that has been postponed by lack of funds and preempted materials and of cushioning the inevitable deflation in inventory values. All of this requires cash. To take from them almost one-half of their normal profits, which will inevitably shrink in the months to come, seems excessive and is hazardous to the survival of the industry.

I doubt if anyone appearing before you representing corporation interests will protest your position that a high rate of corporate normal tax is necessary under war conditions; but there is a point beyond which we believe it is dangerous to go, and beyond which survival of the civilian economy is put in jeopardy.

To be specific, we believe that the corporate normal and surtax rates combined should not exceed 40 percent.

Excess-profits tax.—The excess-profits tax rates of the 1941 Revenue Act were graduated from 35 to 60 percent. The present rates are 90 percent of all income falling within the excess-profits bracket. Moreover, the invested capital credit is to be reduced and this throws a larger portion of income for many corporations into the excess-profits brackets. The combination of the change in rates, the method of their application, and the change of the invested capital credit results in most corporations having their effective excess-profits tax rates very drastically increased.

Under a 90 percent excess-profits tax there is little incentive left for any corporation to maintain efficient operation and to avoid extravagant expenditures. Such a high rate may seriously interfere with war production. Should this war last for several more years, very little operating profits, if any, will remain. There will be practically nothing left with which to stabilize economy, sustain employment, convert from war to peacetime activity and for retailers particularly to resume full-scale activity in the distribution of civilian goods.

Economists tell us that under the present controlled economy there will be a pent-up consumer demand for civilian goods, the production of which has been suspended, and that this should help greatly to sustain the post-war economy. Funds will be needed to provide stocks of new merchandise to supply that demand.

The proposal of the Ways and Means Committee for a post-war credit, evidenced by nonnegotiable, non-interest-bearing bonds in the form approved by the committee, with which to enable taxpayers to convert their businesses to peacetime activity and to maintain employment, should be restored to the bill with this exception, that the amount refunded should not be subject to a capital-gains tax of 15 percent as was proposed by the committee in the last days.

Finally, with respect to corporation taxes, when so large a percentage of the earnings are taken by the Government, it is of the utmost importance to define accurately what is true normal profit and what is actually excess profit. We have repeatedly advocated before your committee the principle that the excess-profits tax should not invade the field of normal income.

Senator VANDENBERG. If you get a real definition, you would not care what the excess-profits tax was.

Mr. IGLAUER. That is right, but it involves values of inventories and other important items. It is important to know what true normal profits are.

In this respect also I have been requested by the American Retail Federation in order to save their time in their presentation to come later, to say that they stand with us on this request for a 15-percent post-war credit.

Senator CLARK. Mr. Iglauer, what you are doing is suggesting a retail-sales tax in exchange for the revision of the House measure as it is now set up on corporate income?

Mr. IGLAUER. No; it has no relation to it. We have from the beginning felt, as good citizens and as realisits, that in order to raise the enormous sum of money that is needed, the sales tax should be added to what has already gone before.

Senator CLARK. You are suggesting changes in corporate income structure that would mean a very material loss in the amount of revenue raised in the bill, and at the same time you are proposing a retail-sales tax to increase it.

Mr. IGLAUER. There is much to be said about that. I do not want to take too much time, but I will just point out one thing. There is very little likelihood that the dividend rates of corporations can be continued in 1943, or even in 1942, at the rate of the previous years and as you increase the corporation rates, you merely reduce the yield from personal income taxes, because there will not be the dividend income to the individual that there was, and therefore the Government loses somewhat the income that it would expect to get.

Senator CLARK. That is true, but your suggestion is undoubtedly resulting in a very material decrease of the amount of revenue to be raised by the House bill.

Mr. IGLAUER. Not a good deal. The House bill calls for 90 percent now, and the normal and surtax of 45, and we are saying that we think that 40 is the limit for safety. And we believe, based on our experience with our corporations, and with others with whom we have had contact, that the extravagance of operation which results from the let-down of the desire for economy of operation and for profits will result in less tax, and that is all.

We believe you have gone past the point of diminishing returns. Every day we are faced with problems by our subordinate groups in our corporations who say the Government gets 90 percent of the profit anyway and they might as well spend the money for this, that, and the other thing, when it comes to advertising and a lot of other things, rehabilitation, if you can get the material.

We believe, wholly apart from the sales tax, that we should stop somewhere on the corporate tax set-up. In other words, the English system, if I remember rightly, calls for 100 percent with a 20-percent drawback, a 20-percent refund.

Senator TAFT. Mr. Iglauer, assuming that the sales tax would add 2½ billion dollars, as you have presented it here, and the loss in reducing the normal rates from 45 to 40, even if you consider that would not add over $140,000,000 it can hardly be said you would add 2½ billion dollars net.

Mr. IGLAUER. The two considerations are entirely separate. They are not related to each other. We are simply saying on the merits of the question of the corporate tax alone there is good reason why there is some top limit beyond which you go only with danger to the income of the Treasury.

We think where the rates are so high you are going to lose in the individual income tax some part of the revenue that you might have expected because there will not be dividends and income from partnerships sufficient to make up for it.

It will be eaten up by the tax and therefore will not be available in your individual income-tax returns, especially in the upper brackets.

We believe also that the post-war credit which we are asking for gives the Government the use of the money during the war and does give some incentive for saving, which the present system, in my opinion, does not.

The present system will lead to extravagance in operation. We have seen it over and over again.

Estate and inheritance taxes.—We again renew our plea to you that you include in the revenue act, under estate and inheritance taxes, a provision to amend section 812 of the Internal Revenue Code so as to provide that insurance taken out by a taxpayer, payable irrevocably to the Treasurer of the United States, to the extent that such insurance is used for the payment of Federal estate and inheritance taxes be exempt from inclusion in the assured's gross estate, for the purpose of Federal estate and inheritance taxes, now or hereafter levied. The excess, if any, of such insurance proceeds over the amount so used for the payment of such taxes should be repaid without interest to the estate of the decedent, and should be subject to the Federal estate and inheritance tax.

Our committee feels justified in making this suggestion because in many retail establishments as well as in other corporations, partnerships, and proprietorships, the entire savings of the principal owners are invested in a single enterprise, the dispersion of which would be disastrous to the business enterprise itself as well as to the revenue to the Treasury.

Heavy estate taxes, particularly those in the existing statutes, without the protection of insurance on the life of a taxpayer, may well cause liquidation of the business resulting from a forced sale, with consequent unemployment. This could well result in inability of the Government to make collection of a large portion of the estate tax.

This plan would permit a taxpayer to make provision to meet the estate and inheritance tax liability; it avoids the pyramiding of estate and inheritance taxes present under the existing law; it avoids the liquidation of the business with resulting unemployment; and it guarantees the Government's collection of estate taxes.

We have confined ourselves to a statement of our position without burdening you with statistics of which you have already had plenty.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Iglauer.

Mr. IGLAUER. I would be glad to answer any questions that you wish to ask.

The CHAIRMAN. Are there any questions?

Senator DANAHER. Mr. Chairman.

The CHAIRMAN. Yes, Senator Danaher.

Senator DANAHER. Would you choose to tell us your experience in the collection of the cosmetics tax? Last year, you remember, you forewarned us against possible difficulties. I wonder how it has been operating in actual practice.

Mr. IGLAUER. We had months of uncertainty and months of pleading for clarification of definitions, and we made it work after a while.

I think our pleading was not only on the cosmetics tax.

Senator DANAHER. That is right.

Mr. IGLAUER. It was also on the difficulties of definition in the fur taxes and jewelry taxes, because those caused us more trouble than the cosmetics taxes.

Senator DANAHER. Have you finally worked out the difficulties in the collection of the jewelry taxes?

Mr. IGLAUER. I think the only way we can test that is by the actual difficulties that the Bureau of Internal Revenue has had. We do not know ourselves whether we have collected what the Government wants

us to collect, and I do not think the Government knows exactly, because of the difficulty in determining fur content, particularly in fur-trimmed garments.

That was the difficulty from the beginning, and those taxes are difficult to define. I do not think we are over that hump yet.

We are all collecting taxes and we are standing up so straight that we are leaning over backward in order to get the taxes the Government wants.

Senator DANAHER. You remember you advocated last year that we impose no tax on jewelry on individual sales of less than $3, and you asked us then to impose at the manufacturers' level.

Mr. IGLAUER. That is right.

Senator DANAHER. Have you had any difficulty with that?

Mr. IGLAUER. Our difficulties are the difficulties of expressing the price to the customer adequately. There are competitive situations which develop. For instance, one store in town in furs and in jewelry will prefer to express the tax in the price of the item or the garment.

Another firm will express it separately, as a separate item, and the customer is confused. We had customers come from one store to another in our own town asking, "What is wrong here? Who is collecting the tax and who is absorbing the tax?" Even though there is a prohibition and a deterrent fine against absorption of a tax, it was difficult to control the statements made by sales people to customers. We had to call the attention of one firm of our town to statements made by sales people, which was in contradistinction to the method used by most of the retailers.

That situation exists where you have a manufacturer's excise tax which permits the price to be expressed in two different ways. The sales tax we propose should be with a mandatory pass-on expressed as a separate item on the invoice or sales check or evidence of sale, so that all retailers will be on a uniform basis.

So the tax will be where you can see it, where the auditor can see it, where the tax auditor can see it. That is one of the problems we have. We still have that problem with silver ware, jewelry, and with furs.

There are some retailers who prefer to express the price as one price in order to overcome the sales resistance of the customer. In particular, the fur tax, it was evident that the tax itself was interfering with the sale of garments, because after you sold a $1,500 fur coat to a customer, then you had to start all over again to sell the $150 tax.

It has never been a problem with me.

Senator DANAHER. Thank you.

Senator TAFT. Has that section of the bill successfully prevented advertising that they are absorbing the taxes?

Mr. IGLAUER. I think that has been entirely successful. I think most merchants, reputable merchants, are so afraid of the consequences of such an act on their part that they are pretty well observing the tax law, but I do think that in any general sales tax there should be a provision which makes it mandatory to show the item as a separate item of tax.

Senator TAFT. Mr. Iglauer, let me ask you this: Your association has had experience with sales taxes in a fair number of States. Particularly what States are there that have sales taxes?

Mr. IGLAUER. There are 17 or 18 States that have sales taxes.

Senator TAFT. If we start to write sales taxes in the bill, are there any particular States that seem to have a better system than other States?

Mr. IGLAUER. Of course, Senator. You know in your own State——

Senator TAFT. In my own State I know, but I do not know how it works in other States.

Mr. IGLAUER. The methods in various States vary, as you know. In one State there is a peculiar tax which is in the nature of a privilege tax, yet that is also shown as a separate item on the sales check. The difficulty which was commented upon by the House Ways and Means Committee with Mr. Puckett was that of the bracket system in the small sales, 10 cents or less.

With 10 cents, of course, the tax would be one-half cent.

That is not a serious matter, because a bracket system can be established which will return an adequate sum and which will not give any profit to the person who collects the tax.

Senator TAFT. Do you prefer a bracket system?

Mr. IGLAUER. Yes; I would prefer a bracket system.

You see, Ohio has a bracket system.

Senator TAFT. Yes, Ohio has a bracket system; but the different States vary as to exemptions. In Ohio they exempt food.

Mr. IGLAUER. Yes; all States vary considerably. I do not believe in the exemption of anything except the things needed for the war effort by the Government plants and other plants, because of the fact that you already have justified a tax on food through the processing tax.

Senator TAFT. By exempting food you might meet part of the objection that this is an unduly burdensome tax on the lower-income group, because if you exempted what the family purchased in stores, I assume it would be equivalent to an exemption of about $500 a year.

Mr. IGLAUER. It would be a substantial diminution in the sales-tax revenue.

Senator TAFT. Yes; I believe it cuts off about 20 percent. In Ohio, when we cut it out, we lost about 20 percent.

Mr. IGLAUER. Of course, you gain something by the increase of volume. I think when you compare the effects of inflation, with prices rising 30, 40, or 50 percent, with a 5-percent sales tax as against the low-income man, he suffers five times as badly with inflation as he would with the 5-percent sales tax, and the 5-percent sales tax will have a deterrent effect on inflation.

All economists agree that a sales tax is regressive in character and is deflationary.

Senator VANDENBERG. You mean all economists except those in the Treasury.

Mr. IGLAUER. I guess that is right, Senator.

Senator TAFT. If we tried to draw up a sales tax here, would you advise following the system in any particular State? Is Ohio's sales tax any better than anybody else's, or are there any two that ought to be followed?

Mr. IGLAUER. Of course, we think ours is the best, that is, Ohio thinks its taxes are the best, but it has a number of factors in it that you know about. It pays a small percentage for administration; it pays the distributors of the tax stamps a very small percentage, and what is more important, it pays to charitable organizations 3 percent of the face value of the stamp itself for collecting the stamps, which means that the consumer asks for the stamp and gets it, which produces the collection of the tax. Now, I am not advocating that because I am from Ohio, but there are a number of others who advocate it. We had a conference of our retailers representing several States, and many of them would not like to see the stamp tax used, the type we had in their State.

So I am fair in presenting to you that there are objections by some States who have had other experience.

Senator TAFT. In what other State has it worked out well?

Mr. IGLAUER. In Illinois. There are 17 States, and I am not familiar with the workings in all States, but Mr. Puckett, who represents a group of over 60 stores in all parts of the United States, has had no great difficulty in the various States.

They found a way to do it. I think the simplest method, of course, is the expression of the tax as a separate item on the invoice, or on the evidence of sale, in order that it may be audited and in order that every concern shows clearly what the tax is, and there is no disposition to absorb the tax one way or another.

That is a competitive situation which must be dealt with fairly.

The CHAIRMAN. Thank you, Mr. Iglauer.

Judge Fletcher.

STATEMENT OF R. V. FLETCHER, WASHINGTON, D. C., VICE PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. FLETCHER. Mr. Chairman and gentlemen of the committee: My name is R. V. Fletcher. I live in Washington. I am vice president of the Association of American Railroads.

I appear here on behalf of the railroads of the United States, not only the class I railroads which belong to the association by which I am employed, but I am authorized to say that the brief statement which I shall make has the endorsement and approval of the Shortline Association as well.

The counsel for the Shortline Association found it impossible to be here today, and he asked me to say on his behalf that he had gone over this material and discussed the matter with me, and he is entirely in accord with the views I shall endeavor to express. So that I am the spokesman here for the railroad industry as a whole, an industry which has been considered, and I believe properly so, as the second largest in the United States, exceeded in the amount of its investment and the number of its employees and the like, only by agriculture.

The railroads of the United States represent an investment of something like $26,000,000,000. They have a mileage of more than 250,000 miles. They employ at the present time about 1,250,000 persons.

They paid more than half a billion dollars in taxes in 1941. They will probably pay three-quarters of a billion dollars in 1942.

I do not need to take the time of the committee in discussing the importance of the railroad industry, but I may mention its war accomplishments.

I think it is generally understood, somewhat to the surprise of certain individuals, that the railroads have done a wonderful job in transporting war materials and men since the Pearl Harbor incident and that they are essential to the success of our Nation in war and to the preservation of our economic system in time of peace.

I would like to file with the committee, if I may, a statement here which goes back to 1921. It shows the total operating revenue of the railroads, the operating expenses, the amount of taxes they paid each year, the net railway operating income, and their net income.

The CHAIRMAN. You may file it, Judge.

Mr. FLETCHER. It is understood that "net income" is the amount left to the railroads after payment of their operating expenses, their taxes, and their fixed charges.

(The statement referred to is as follows:)

Revenues, expenses, and net income, railways of class I in the United States, years 1921–41

Year	Total operating revenues	Total operating expenses	Taxes	Net railway operating income	Net income
(1)	(2)	(3)	(4)	(5)	(6)
1921	$5,516,598,242	$4,562,668,302	$275,875,990	$600,937,350	$313,592,762
1922	5,559,092,708	4,414,522,334	301,034,023	760,187,319	369,573,432
1923	6,289,580,027	4,895,166,819	331,915,459	961,955,457	554,995,304
1924	6,021,496,325	4,507,885,037	340,330,686	973,837,202	558,469,356
1925	6,122,509,856	4,536,880,201	358,516,046	1,121,076,341	700,831,364
1926	6,382,939,546	4,669,330,736	388,922,856	1,213,089,966	809,054,202
1927	6,130,300,270	4,574,177,821	376,110,250	1,067,985,495	672,899,809
1928	6,111,735,511	4,427,995,036	380,432,415	1,172,804,100	786,823,584
1929	6,279,520,544	4,508,056,262	390,682,634	1,251,697,938	896,806,611
1930	5,281,105,870	3,930,928,087	348,553,963	868,878,773	523,907,472
Average 1921–30	5,900,096,900	4,502,561,733	350,738,122	999,250,995	618,002,090
1931	4,188,343,244	3,223,574,616	303,528,090	525,627,852	134,764,911
1932	3,126,760,154	2,403,444,895	275,135,369	326,298,008	[1] 139,203,821
1933	3,095,403,901	2,249,231,779	240,623,100	474,295,163	[1] 5,862,836
1934	3,271,566,822	2,441,822,767	239,624,802	462,652,379	[1] 16,887,078
1935	3,451,929,411	2,692,741,419	236,944,085	499,819,118	7,539,127
1936	4,052,734,139	2,931,425,050	319,752,721	667,347,115	164,630,041
1937	4,166,068,602	3,110,064,934	325,695,165	690,203,925	98,057,740
1938	3,505,490,753	2,772,199,007	340,781,954	372,873,771	[1] 123,471,074
1939	3,995,004,251	2,918,209,708	355,077,558	588,826,083	93,181,534
1940	4,200,000,653	3,080,417,209	380,394,774	6.2,133,478	188,851,151
Average 1931–40	3,720,990,193	2,760,113,139	304,312,868	519,008,035	40,159,670
1941	5,346,699,997	3,664,232,230	347,230,071	988,255,787	499,765,138
Year ended June 30, 1942	6,203,035,000	4,143,089,000	786,822,000	1,117,021,000	[2] 620,805,000

[1] Denotes deficit.
[2] Partially estimated for month of June 1942.

Mr. FLETCHER. I want to call attention to the fact that for the year ended June 30, 1942, with the net income for June partially estimated, the railroads will have as a net income about $620,000,000.

That is in very striking contrast with the average for the 10-year period ending in 1940, which was just slightly over $40,000,000. There was a deficit in net income in 1938; there was a deficit in 1934; there was a deficit in 1932 and 1933.

I make mention of this figure of $620,000,000 net income for the reason that I would like to make some suggestions as to how that can be profitably disposed of if we can get an amendment to the act which I shall discuss. The first problem that I want to present to the committee has to do with a suggested amendment of section 22 (b) (9) of the Internal Revenue Code.

That section, as it is written now, was enacted originally in 1939, when this committee passed upon the fundamental questions that were there involved. We were seeking at that time, as we are seeking now, to have such a change made in the tax law as would permit railroads, and other corporations for that matter if they cared to use the permission in the statute, to buy in their own securities and retire them, thereby reducing their fixed charges. This Congress, responding to that appeal, provided in the law as it stands now, that any corporation may purchase its own outstanding securities without tax penalty provided they could get a certificate from certain governmental authorities, to wit, the Bureau of Internal Revenue or the Interstate Commerce Commission, or the Reconstruction Fi ance Corporation, that they were in an unsound financial condition.

It was necessary to get such a certificate before the privilege granted in that statute can be availed of.

I must confess at the time when that was enacted into law I had some hopes that it could be used by the railroads, even with that condition, but the experience of 3 years has demonstrated conclusively that it is of no advantage whatever either to the railroads or, indeed, any other corporation, so far as I am advised, because of the consequences which would follow the granting of the certificate of "unsound financial condition."

I had been hopeful that the very fact that the securities of a particular railroad were selling far below par would be sufficient evidence of unsound financial condition, and that applying for such a permit or privilege or certificate would be a technical compliance with the law, having no substantial practical adverse effects.

But it did not work out that way. It was soon discovered whenever a railroad corporation applied to the Interstate Commerce Commission or the Reconstruction Finance Corporation for a certificate that they were in an unsound financial condition, the consequences would be so serious that they could not avail themselves of that privilege.

For example, it may be that railroads would have to borrow money from the Reconstruction Finance Corporation, as they sometimes have done. Under the law it is necessary before that loan can be passed upon and approved by the Reconstruction Finance Corporation, that they should get a certificate from the Interstate Commerce Commission that they are not in need of reorganization under the bankruptcy law.

So you can see the situation that would confront a railroad company if on one day it applied for and got a certificate that it is in an unsound financial condition and next week applied to the Interstate Commerce Commission for a certificate that it is not in need of reorganization.

Furthermore, the effects upon the general credit of the railroads, to the extent to which credit exists so far as a railroad security is

concerned, were such that no railroad of any consequence, except one, I believe, emerging from reorganization has ever undertaken to apply for such a certificate that it is in an unsound financial condition.

We are back here, therefore, pleading with this committee to allow those purchases of securities to be made, where they can be made at a substantial discount without any tax penalty. Particularly are we asking the Congress to eliminate that provision which makes it a prerequisite to the use of the privilege that it should be found to be in an unsound financial condition.

I do not know of anything, Mr. Chairman, that is more important to the railroads right now than to reduce their fixed charges. The bankruptcies which have occurred throughout the country—and one-third of the mileage of the country is either now in bankruptcy or has been in bankruptcy recently—were due to the heavy burden of fixed charges. The railroads were able to carry those fixed charges in times of comparative prosperity; they found them an intolerable burden in the depression period that followed the collapse of 1929.

Many railroads remained out of the bankruptcy court only by borrowing money from the Reconstruction Finance Corporation and elsewhere; others found it necessary to seek relief in section 77.

If we could get something whereby this substantial surplus which is now being accumulated by the railroads in wartimes can be expended for the purchase and retirement of their securities, thereby reducing the principal and the interest charges, we would avoid many bankruptcies in the future, and make a forward step, and a most constructive one, it seems to me toward insuring the continuance of these important agencies of commerce in the post-war depression period, if we have a depression period in the post-war era as many of us fear.

Senator BROWN. The Treasury charges you with the difference in profit between the figure which you pay for the bond and par?

Mr. FLETCHER. That is right.

For instance, if a railroad goes into the market and buys bonds of the par value of $5,000,000 and it can purchase them for $3,000,000, the $2,000,000 is charged as income.

Senator BROWN. For that particular year?

Mr. FLETCHER. For that particular year. It is added to the income of the railroads and they pay their tax on that, just the same as they do on any other legitimate item of income.

What we are trying to do is to get such an amendment to the law as would require the Treasury or the Bureau of Internal Revenue, not to charge to income the difference between the par value and the purchase price of these depressed bonds and the law now does so provide, provided you get this certificate of unsound financial condition.

Mr. Chairman, we have discussed this matter with the Treasury. The people who are concerned with legislation have been very kind, indeed, and very considerate in listening to our explanation on this matter, and I think I am authorized to say that they have been very sympathetic with the desire of the railroads, and perhaps other corporations—but I speak only for the railroads—to get relief in such

a form as will permit the railroads to reduce their fixed charges and thereby ultimately increase the amount of taxes which they pay.

You see, this change which we ask for does not represent any depletion of revenue. As the thing stands now, no corporation can afford to buy its bonds at the reduced rate, because of the heavy tax burden.

If, however, they are permitted to buy those bonds and retire them, then, of course, the burden of fixed charges will be reduced, and since fixed charges is a deductible item from income, obviously the income will be correspondingly increased and subjected to tax.

Senator BROWN. Is there any justification for doing it for the railroads and not doing it for corporations generally?

Mr. FLETCHER. Of course, those of us who labor in the railroad field might say so, Senator, and I think probably with force, namely, that they are public-service corporations, that they are essential to the welfare of the country, that they are a regulated industry, that we do not fix our own charges, we do not fix the wages we pay, we do not have much control over our property. At the same time I do not see any reason why it should not be extended to other corporations as well with beneficial effects so far as those corporations are concerned, but possibly with a somewhat lesser impact upon the public interest.

The Treasury, as I have said, has listened sympathetically to our contention, and I hold in my hand a draft of an amendment to the present law which I sincerely hope will be accepted by the Treasury as satisfactory, if the matter is referred to the Treasury.

May I, Mr. Chairman, put into the record my suggestions as to how this section 22 may be amended so as to accomplish the purposes which I advocate?

The CHAIRMAN. You have the suggested amendment?

Mr. FLETCHER. The amendment is here. It consists of nothing except the omission of certain words which are indicated here by brackets, namely, that part of the law which requires the finding of unsound financial condition.

The CHAIRMAN. I see.

Mr. FLETCHER. I have only one suggestion to make in reference to this draft and that is this:

Under the law as it stands now and as it is here shown in this particular draft, only those securities which were outstanding on June 1, 1939, can be bought in without tax penalty.

Now, it has seemed to us that there is no reason for that distinction, and it is of importance to certain railroads like the Erie, the Chicago & Eastern Illinois, and perhaps the Chicago & Great Western, that have recently reorganized under section 77 of the bankruptcy law and have issued a number of new securities. I see no reason why those securities should be treated differently from securities which were in existence on June 1, 1939. I am, therefore, respectfully suggesting that that date be omitted from the statute so that all railroad securities, whenever they may be issued, may be bought in at a discount without tax penalty.

This was presented, Mr. Chairman, to the House Committee on Ways and Means, and very elaborate hearings were held by that body on it, and the House did make one slight change in the statute which

I will mention. The present law expires, by its own terms, on December 31, 1942.

The House went so far as to extend that time so as to allow that privilege for an additional 3 years. As it passed the House, the act provided that it shall not be available after December 31, 1945.

I mention that to show that the House gave some consideration to the matter, but due to certain circumstances over which nobody, I presume, had any control, they did not eliminate the objectionable provision about the certificate as to unsound financial condition.

I should like to put into the record the proposed amendment. I hope it will be endorsed and approved by the Treasury yet, Senator.

The CHAIRMAN. Yes; it may be inserted into the record.

(The amendment referred to is as follows:)

Section 22 (b) (9) of the Internal Revenue Code (relating to income from discharge of indebtedness is amended to read as follows: (Deleted matter in brackets; new matter in italics).

"(9) INCOME FROM DISCHARGE OF INDEBTEDNESS.—In the case of a corporation the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined [if—

"(A) it is established to the satisfaction of the Commissioner, or

"(B) it is certified to the Commissioner by any Federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal agency authorized to exercise regulatory power over such corporation.

that at the time of such discharge the taxpayer was in an unsound financial condition, and] if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113 (b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term 'security' means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge *to which the provisions of paragraph (10) of this section are applicable, nor to any discharge* occurring before the date of enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, [1942] *1945*."

Senator VANDENBERG. I should think there would be a general beneficial effect on the general market value of railroad securities in the hands of private investors if the railroads would be encouraged to be substantial buyers in the market.

Mr. FLETCHER. That has been the common opinion. I do not know whether that would happen in the case of railroad securities or not. Frankly, I have been somewhat discouraged and a little bit downcase by the fact that even in the face of rather large earnings railroad bonds do not seem to improve in the market. I am afraid it is due to the profound conviction on the part of a great many large investors that the railroads are going to run into terrible difficulties after the war period is over, and that they will be confronted with some of the adverse economic conditions that developed in the past 10 years.

Senator VANDENBERG. Or that they are going to run into Government ownership.

Mr. FLETCHER. It may be, Senator, although I doubt that. Some of us who are concerned about the future of the railroads are anxious to see if, by legislation and otherwise, we cannot prevent that slump in railroad credit that some people seem to anticipate.

Senator DANAHER. Judge, the questions that have been asked suggest one further inquiry.

What percentage roughly, of the railroads, would benefit by the change?

Mr. FLETCHER. I have a little table here which I will just refer to, Senator, with your permission.

Senator DANAHER. Yes, please.

Mr. FLETCHER. I have a little table here that shows—pardon me for reading these figures—that the solvent railroad companies, those that so far have not resorted to bankruptcy and euphemistically we refer to them as solvent, have now outstanding on the New York Stock Exchange bonds in the amount of $4,780,790,000. The so-called receivership and trustee companies have outstanding $2,279,800,000.

Now, when you examine these securities of the solvent companies you will find that the current market value is $1,541,000,000 less than the par value. In other words, the so-called discount amounts to $1,500,000,000 in the case of the solvent companies and about $1,750,000,000 in the case of the insolvent companies.

So that now it would be possible, if the railroad had the money and could make the contracts, they could reduce their fixed charges by $3,339,000,000 if they were to buy all of the bonds which are now selling at a discount.

Now that would not happen, of course. All of them could not be bought. Some railroads would not have the money.

But as Senator Vandenberg has suggested, the enactment of a statute of this kind, and particularly the entry by the railroads upon a program of purchasing the bonds, might have an effect of increasing the price to some extent, although I am afraid not as much as I would like to see them increased.

But, if the railroads could thereby reduce their fixed charges by 3⅓ billion dollars they could relieve themselves of fixed charges of about $120,000,000 a year, assuming 4 percent is about the average rate of interest on these securities.

If they could reduce the fixed charges by $120,000,000 they would greatly improve their financial condition, and of course that $120,000,000 would be added to the taxable income of the railroads and subjected to taxes in the ordinary way.

Senator RADCLIFFE. Mr. Fletcher, I understood you to say just a moment ago that there was a certain amount of uncertainty or pessimism in regard to the future of railroads and it has a rather depressing effect on railroad securities. Would not that apply to many other kinds of businesses, or is there any special reason why, in your opinion, it should be accentuated as far as railroads are concerned?

Mr. FLETCHER. It would apply, of course, to others, if the same feeling exists. There is a tendency in the investment market to go to stocks rather than bonds. You can understand readily why that

would be. That would be more or less of a hedge against inflation, so to speak, according to the view of the ordinary economists.

I am a very ordinary economist. That has some effect. My statement applies more to the railroad bonds and securities that are now selling at a very depressed figure in the market, in spite of the fact that the earnings of the railroads are better than they have been for a long time.

Senator RADCLIFFE. When you spoke a moment ago you had in mind merely railroad bonds and not railroad stocks?

Mr. FLETCHER. I was talking about bonds; yes.

Senator RADCLIFFE. Would you say the same attitude is applicable in regard to railroad stocks?

Mr. FLETCHER. You need only look at your market quotations to see how low railroad stocks are to make certain I would have to answer it in the affirmative.

The same depressing effect applies to stocks as to bonds.

Senator DANAHER. You really mean "security" as defined in section 22 (b) (9) with the exception of the words "in existence on June 1, 1939?"

Mr. FLETCHER. "Security" there is defined, Senator Danaher, as interest-bearing obligations.

Senator DANAHER. That is right; but any other certificate of indebtedness issued is also included?

Mr. FLETCHER. That is true.

Senator TAFT. Are profits also involved from buying your own stock? Are the companies buying their own stock?

Mr. FLETCHER. No. I might say, in concluding what I had to say on this subject, in the hearing before the House committee the president of the New York Central, Mr. Williamson, and the president of the Baltimore & Ohio, Mr. White, and the vice president of the Illinois Central, Mr. Connolly appeared before the committee and their testimony can be found in the published House hearings. They are practical railroad men who gave cogent reasons why it would be of tremendous interest to the industry if this change was made. I doubt if they will be here, they certainly will not be here today, and for that reason I would like to call attention respectfully to the testimony of these gentlemen, and to say that that testimony can be examined in the House hearings if any Senator desires to pursue the matter further.

I conclude what I have to say on the subject with this rather confident assertion, that I believe if the matter is referred to the experts of the Treasury, you will find them inclined to go along with the draft which I have put in the record here, with the exception of the change in date. I have not consulted with them about it.

Senator RADCLIFFE. Mr. Fletcher, I would like to ask you a question. I am not quite sure that it is an entirely reasonable one.

Do you feel that there is any matter of general policy which the Government could adopt which would tend to offset the feeling of distress as to the future that you described?

Mr. FLETCHER. Oh, yes, Senator. That is probably another subject, but I have very strong feelings on that, as to what legislation would be desirable in that connection.

My own opinion is we have got to get away from the idea of railroad companies and bus companies and truck companies and airline com-

panies and water companies that are all competing with each other in a mad scramble for traffic. All our transportation should be a coordinated whole. Some day that is going to have to come about if they are to survive as private agencies.

Senator RADCLIFFE. I realize the question is somewhat afield from the present matter, but I thought you had some idea in mind on it.

Mr. FLETCHER. I will pass from this particular topic. I want to get through as soon as I can, Senator.

The CHAIRMAN. Yes.

Mr. FLETCHER. The next question which is of great importance to the railroads has to do with this serious problem of deferred maintenance.

Now here the railroads are doing a splendid piece of work, as I rather exultantly say at this time, in connection with the war effort, handling the freight traffic of the country without serious delays and congestions, doing the best they can with the passenger traffic, moving the troops to the satisfaction of the War Department, and winning the encomiums of all branches of the war service.

In order to accomplish that which is being done, with fewer cars and fewer locomotives than they had in earlier times, they have made a great increase in the efficiency of their train operations, in the loading and unloading of freight.

There has been a marked improvement, partly technological and partly due to improved operating methods in the way in which the railroad business is being handled. But to do that, Senators, has an exhausting effect upon the equipment.

There is scarcely time to repair the equipment as it should be repaired, because it has to be kept moving.

Take the enormous oil movement to the East, which now amounts to about 800,000 barrels a day which has surprised everybody in its magnitude.

You remember at one time, when there was an investigation made by another committee of this Senate, when the president of our association ventured to say if they had the cars—and the cars belonged to private owners, you understand—they could move 200,000 barrels a day. It was considered to be an extremely exaggerated and ridiculous statement, and was so denounced by a high official of the Government.

They are moving 800,000 barrels a day now, and efforts are being made now, through the wise cooperation of the railroads and government, to increase that amount in view of the serious oil shortage in the eastern territory.

Well, all that means a tremendous loss of service life on the part of the railroads, both as to their equipment and as to their track.

Railroads are in funds, so to speak, at the present time as this statement that I have put in indicates. If they could get the men and could get the materials it would be good, sound business judgment to spend larger amounts than they can possibly spend now in maintaining their track and maintaining their equipment.

They are going to come out of this war, I hope, with a commendable record of notable achievement in the handling of the war traffic, but they are going to come out with their tracks more or less run down and with their equipment in a shaky condition, just as they did in the other war, you remember.

You have here the problem, therefore, of what is going to happen in reference to this deferred maintenance and it seems to us to be a sound proposition that there should be written into this revenue bill a provision which would, under proper supervision, which I will mention in a moment, give the privilege to the railroads to set up in their accounts as a charge to operating expenses such amounts as they ought to spend on maintenance at the present time but which they are prevented from spending by reason of the inability to secure the men and materials, the materials of course being controlled by rigid priority orders and I do not quarrel with the policy of the Government in that respect.

I have no doubt these orders are essential to the winning of the war. But the fact remains when these railroads come out of the war at the end of hostilities and are put back on a normal basis, when they have to live on the civilian traffic, they are going to find that they need to spend very considerable amounts in bringing their property back to a proper standard, and they will not have the funds because they will have been paid out in taxes during this period.

Senator GERRY. Do you think the railroads will be able to increase the movement of oil that is going to New England?

Mr. FLETCHER. It is just a question, Senator, of getting the oil tank cars.

If you can get them—and they all belong, you know to the owners of the oil, practically all of them. It has never been the policy of the oil industry to allow anybody to own any of the things that they use, in other words, it is a so-called self-contained industry. They own the oil, they own the wells that produce the oil, they own the pipe lines and they own the tank cars. There is an order which has been put out, I see, by the Secretary of the Interior, who is the Oil Coordinator, that a large number of tank cars now being used in the West for short-haul service shall be thrown into the eastern territory. The railroads will furnish the locomotives, if the cars will be produced.

Senator GERRY. That is what I had in mind.

Mr. FLETCHER. I am hopeful that the 800,000 barrels a day may be increased somewhat. I do not mean to say that they can take up all the slack due to the discontinuance in the movements of tankers. I do not think that can be done.

Senator DAVIS. What was the financial condition of the railroads after World War I?

Mr. FLETCHER. They had a fairly liberal treatment at the hands of the Government during the first World War. They were paid a substantial amount for the use of their property. They were given a 6 months' guarantee of earnings at the close of the war.

Then after the depression in 1922, they entered upon 7 fat years, until the collapse in 1929.

Senator RADCLIFFE. When there were hearings before the gasoline committee, of which I was a member, statements were made again and again that there were about 20,000 tank cars that could be made available for the transportation of oil.

Do you know about what the general situation is now in regard to that?

Mr. FLETCHER. I have the impression, Senator, that practically all of the tank cars available are being used now.

Senator RADCLIFFE. That would mean that practically all of the 20,000 tank cars are utilized at this time.

Mr. FLETCHER. I have an idea that that is true, although I am no authority on that subject.

You understand, Senator Radcliffe, it costs a great deal more to move oil by tank car than by tanker or pipe line.

Senator RADCLIFFE. Yes.

Mr. FLETCHER. In normal times it is not economical to move oil long distances in tank cars.

The CHAIRMAN. What are you suggesting?

Mr. FLETCHER. I am suggesting this, Senator—and I want to get through with this——

The CHAIRMAN. I mean in regard to the ordinary, normal maintenance.

Mr. FLETCHER. May I say in that connection that the Interstate Commerce Commission has very recently entered an order, which bears the date of June 29, 1942, providing that as a matter of accounting, if the railroads make a showing to the Interstate Commerce Commission as to the necessity for the expenditure of funds for maintenance, and also a showing that they cannot get the men and material for that purpose, under special orders of the Commission they may set up in their accounts and charge to operating expenses the amount which the Commission may approve as desirable for that purpose, and our contention here is that it should be written into the statute that in calculating the taxes of the railroads they should be allowed to deduct from income the amount so approved by the Interstate Commerce Commission upon the proper certificate from the Commission.

Senator BROWN. That would not follow as a matter of course?

Mr. FLETCHER. It would not follow except under the strictest supervision, Senator.

I appreciate the fact it must be supervised. Here is the Interstate Commerce Commission that knows the railroad situation thoroughly, of unquestionable integrity, and of approved ability.

If it puts out an order authorizing and permitting this to be charged into the accounts of the railroad, then our contention is that the Government can very safely permit that amount to be deducted from revenue and used in a certain prescribed way.

We propose further that these sums so charged to operating expenses and not actually expended shall be required immediately to be invested in Government securities.

In other words, the Government gets the use of the money immediately and that money is held until the close of the war, and there should be a provision in the act that it must be spent within 5 years after the close of hostilities, spent for maintenance, and if it is not spent for maintenance the funds reserved will then be taxable, either at the rate prevailing in that year or possibly referred back to the year when they were created and taxed at the rate prevailing at that time, as the Congress may see proper.

The CHAIRMAN. On the same principle as inventory reserves, if not taken up in depreciation, would then be returnable at that time.

Mr. FLETCHER. Yes.

Another question has arisen, Mr. Chairman, in this connection, and that is should there be a ceiling or limit on the amount? We have

tried to work on that problem in the railroad industry, and we have examined the amount for expenditures for normal maintenance through past years over a series of years.

And I think it would probably be correct to say that somewhere between 2 and 3 percent of the gross revenues of the railroads have, in a reasonable test period, been expended for that purpose.

So I should think it would not be unreasonable to provide that the ceiling should not be more than 3 percent of the gross revenues of the railroads, or possibly 2 or 2½ percent.

Senator TAFT. How much is that in dollars, just roughly?

What are the gross revenues of the railroads?

Mr. FLETCHER. Will you let me figure that out?

Senator TAFT. I was just wondering how much was involved.

Mr. FLETCHER. I should have been able to answer that question offhand. I will have it in a moment.

Two percent would mean about $120,000,000.

Senator TAFT. And 45 percent of that would be around $50,000,000 of taxes.

Mr. FLETCHER. Yes. If it goes to that point.

I was counting it on a $6,000,000,000 revenue. We are going to run very close to $6,000,000,000 this year. Of course, in normal times it will be less.

Now, in order to shorten my presentation here, I should like to file with the committee a more detailed explanation of this matter, which the experts of the committee or the committee members themselves, might possibly like sometime to examine.

Is it too long, Senator, to put into the record?

The CHAIRMAN. No; you may put it in the record.

Mr. FLETCHER. It is about nine pages.

(The statement referred to is as follows:)

PROPOSAL FOR DEDUCTIONS IN COMPUTING TAXABLE INCOME OF RAILROADS SUBJECT TO THE INTERSTATE COMMERCE ACT OF AMOUNTS FOR MAINTENANCE AND REPAIRS WHICH CANNOT BE CURRENTLY MADE BY REASON OF WAR CONDITIONS, SUBMITTED BY R. V. FLETCHER, VICE PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

GENERAL STATEMENT

By reason of the tremendous volume of war production, diversion of coastwise and inland water traffic, rationing of tires and gasoline, and the necessity for transportation in connection with the war effort, the railroads of the United States are transporting the largest volume of traffic in their history. This is clearly demonstrated by the following tabulation, which shows the tremendous increase in revenue ton-miles and revenue passenger-miles of the railroads for the first 5 months of 1942, as compared with similar periods during the years 1929, 1933, and 1941:

	Revenue ton-miles	Percent increase 1942 over	Revenue passenger-miles	Percent increase 1942 over
5 months ended May 31:				
1929	178,602,879,000	32.2	12,103,102,000	34.6
1933	90,294,655,000	161.7	5,477,971,000	197.4
1941	170,056,830,000	38.9	10,782,683,307	51.1
1942	236,285,003,000	.....	16,292,367,077	.....

Consequently, there has been and will continue to be unprecedented exhaustion, wear and tear of the railroad properties.

Under ordinary and usual conditions, when they are not confronted with difficulty in obtaining the necessary labor and material, railroads maintain and repair their properties currently, and, in compliance with the accounting classifications prescribed by the Interstate Commerce Commission, charge the cost of such maintenance and repairs to their operating expenses. Such expenses are recognized by the Internal Revenue Code as allowable deductions for tax purposes.

During war conditions, the railroads are faced with the difficulty, first, of obtaining material to maintain and repair their properties, second, of providing the necessary labor to apply the material, and third, of performing maintenance and repairs by reason of the interruption of work caused by the heavy movement of traffic. For illustration, the railroads have recently been unable to secure a large amount of critical material, such as steel and other metals, due to priorities regulations, and the Office of Defense Transportation has estimated that the railroads are facing an acute labor shortage in many departments of maintenance and operation and will have to employ 320,000 additional men before the end of 1942. Deferred maintenance under such conditions is inevitable and beyond the control of the railroads.

In consequence of the heavy movement of traffic, income reaches a high level. Unless provision is made for reservation of cash for maintenance and repair work which must be deferred because of war conditions and deduction of the amount so set aside in computing Federal income taxes, the income of the railroads will be overstated and taxes will be paid upon income which does not take proper account of the wear and tear of property used in the production thereof.

Recognizing this situation, the Interstate Commerce Commission, under date of June 20, 1942, issued an accounting order, effective July 1, 1942, providing for charges to operating expenses, currently, of estimated amounts to provide for the cost of maintenance and repairs which the railroads are unable to undertake or complete during any calendar year due to inability to obtain material on account of priority regulations or shortage of labor or otherwise, the amount so charged to be concurrently credited to a maintenance reserve account. The deferred maintenance can only be set up upon authority of the Commission, upon application therefor, stating full particulars concerning the nature of the maintenance and repair work and an estimate of the cost thereof.

The Commission's order further provides that to the extent provision is made for deferred maintenance and repairs an amount of cash or United States Treasury securities equal thereto shall be deposited in a special account. Funds under such restrictions will thus be available when the maintenance and repair expenditures can be made by the railroads.

The Commissioner's order not only insures that current railroad statements will correctly set forth their true income after consideration of all elements bearing upon the condition of railroad properties, but makes provision for setting aside funds or securities for the purchase of material and the employment of labor required to make good in subsequent years the deferred maintenance set up upon authorization of the Commission. The use of the funds thus set aside will aid the war effort and will provide a much-needed cushion with which to combat any slump in industry and business conditions after conclusion of the war.

The Commission's order has solved the situation insofar as depicting the true corporate income and making provision for the future is concerned, but the railroads will be seriously prejudiced if some action is not taken to relieve the situation from a tax standpoint. Provision should, therefore, be made in the 1942 Revenue Act permitting the railroads to deduct for tax purposes the amount of deferred maintenance and repairs which the Interstate Commerce Commission will authorize the railroads to include in their accounts.

PROPOSAL OF THE RAILROADS

The railroads urge the enactment by Congress of legislation which will permit the deduction for income tax purposes of the deferred maintenance accrued in their accounts upon specific authorization of the Interstate Commerce Commission. The Internal Revenue Code does not specifically provide for a deduction to cover maintenance and repairs not actually performed. Nor does it appear

that there is any possibility that any interpretation of existing provisions of the code would authorize deductions for charges of this character. The code, therefore, should be amended to provide for deduction of proper allowances for deferred maintenance. Such deduction would be analogous to the allowances now provided for depreciation and amortization in sections 23 (l) and 23 (t) of the code. It is suggested, therefore, that there be added to the code a short, concisely worded subsection, designated as 23 (u)—deferred maintenance, and that there be added an additional section designated as section 125, stating the terms and conditions under which the deduction may be taken. The suggested amendments need not be complicated. They may merely provide—

1. Deductions for deferred maintenance based upon prior authorization of the Interstate Commerce Commission and limited to taxable years beginning after December 31, 1941, and during the war period.

2. Investment of the amount of such deferred maintenance in United States Treasury securities to be held in the corporation's treasury until disbursed in settlement of the charges incurred in making good the deferred maintenance.

3. Deferred maintenance not expended within a 5 year period beginning with the first day of the first calendar year after peace is declared, by reason of reduction in price level, or otherwise, to be included in taxable income, and a corresponding amount of United States Treasury securities released.

The proposal herein suggested would apportion the taxpayer's payments in proper relation to income. It would prevent taxation of income without proper adjustment for wear and tear of property used in its production. It would make the amount of the deferred maintenance currently available for the purchase of Government securities and would create a fund to be used for the purchase of materials and the employment of labor in the post-war period.

SPECIAL SITUATION OF THE RAILROADS

While it is reasonable to assume that all business enterprises employing plant and equipment in the production of income will experience some difficulty, varying in degree, in providing proper maintenance during the war, the following conditions warrant the adoption of special provisions for deferred maintenance with respect to railroads.

1. The welfare of the Nation depends upon the maintenance of adequate and efficient railroad transportation. Trade and commerce of the country can not flourish and develop without the aid of such transportation. The fact has frequently been recognized and declared by Congress in legislation. It is, therefore essential that the vast railroad plant not be permitted to deteriorate and become physically bankrupt, and that adequate and proper provision be made for the restoration of railroad properties to proper physical condition after the war period.

2. Railroads are a highly regulated industry with respect to the matters here under consideration. Railroad accounting is regulated by the Interstate Commerce Commission pursuant to law, and is uniform throughout the industry. There is no such regulation and uniformity of accounting with respect to most other industries. Railroad accounts and affairs are regularly policed by the Commission's examiners, whereas the policing of the accounts of other industries is generally discretionary. By reason of the degree of supervision and control exercised by the Interstate Commerce Commission with respect to railroad accounting, it is appropriate, as a practical administrative matter, for Congress to adopt the proposal herein suggested without detriment to the public interest.

3. The using up of property is a cost of producing income, and is an allowable deduction in determing taxable net income. Such deduction may be in the nature of maintenance and repair expenditures which restore property, or depreciation charges, or a combination of both items. Unlike most other industries, however, the railroad industry is largely dependent upon maintenance and repair expenditures to make good wear and tear of property. Depreciation allowances have generally been limited to equipment. By mandatory order dated June 8, 1942, the railroads of the United States have for the first time been required by the Interstate Commerce Commission to make charges for depreciation to operating expenses applicable to certain classes of road property, commencing January 1, 1943. However, the track structure, consisting of rails, ties, ballast, etc.—a substantial part of the railroad plant—is not embraced within the requirements of the Commission's order, and road property included in the order is not required to be treated as depreciable property in the year 1942. Unless provision is made for deduction for deferred maintenance as

herein proposed, it is manifest that railroads will be deprived of the opportunity to make good the extraordinary exhaustion, wear, and tear of a large part of their property attendant upon the war effort.

4. So far as equipment is concerned, railroads make charges to operating expenses for depreciation because of exhaustion, wear and tear of property not restored by current maintenance and repairs. The same situation would exist with respect to certain classes of road property, commencing January 1, 1943, to the extent that the railroads are permitted by the Commissioner to change from the retirement to the depreciation method of accounting. However, railroads will not be able to make good the excessive exhaustion of railroad equipment and road property, such as bridges and station buildings, resulting from the unprecedented volume of traffic now being transported by them, through the medium of rates for depreciation now applicable to equipment and those which may be made applicable to road property after January 1, 1943.

5. Business enterprises generally take care of excessive wear and tear of plant and equipment by including the amount thereof in the cost of production of the product manufactured and sold or by accelerating the rates of depreciation applicable to such plant and equipment. In bulletin F, revised January 1942, it is specifically recognized that the useful life of some depreciable property, or items thereof, may be affected by a radical increase in plant activity, and that accelerated rates of depreciation may be allowed to the extent that the excessive wear and tear of plant and equipment is not arrested by a simultaneous increase in charges for maintenance and repairs.

6. But the railroads will not, as a practical matter, be able to secure accelerated rates of depreciation for application to equipment and road property. The rates of depreciation determined for application to railroad equipment and road property must necessarily be predicated upon the past policy of railroad management with respect to maintenance and repairs (regulations 103, secs. 19.23 (1)-1 and 19.23 (1)-5, and bulletin F, supra). They have experienced no period like the present, and the extent to which rates of depreciation would have to be accelerated by reason of the present excessive use of their properties is not susceptible of reasonable proof or measurement. Moreover, because of the size and life of the depreciable units of railroad property, it is not practicable for the railroads to accelerate rates of depreciation to take care of the temporary increased use of their properties. A complete locomotive, a complete freight train car, a complete structure, etc., comprise the railroad unit of depreciable property. All of the units to which rates of depreciation are applied have a long-life expectancy. Rates of depreciation are predicated upon the large unit with a long life being maintained in good condition by ordinary current repairs, the costs of which are chargeable to expenses of operation. Other industries base their depreciation charges on smaller units having shorter lives, and are able more effectively to translate increased plant activity into accelerated rates of depreciation. Also, other industries treat many items of property as depreciable units which the railroads treat as parts of units and, therefore, they become to the railroads maintenance and repair expense when replaced.

7. With relatively few exceptions, the railroad plant now being used was acquired many years ago. The property which is being rapidly exhausted in the handling of the present large volume of traffic, therefore, represents in a very large degree the property which was provided by railroad investors prior to the war. Railroads, as a consequence, have not derived much advantage from the provisions of the Internal Revenue Code permitting rapid amortization of defense facilities, and have not been able to protect themselves, by contract or otherwise, against the extraordinary exhaustion of their properties resulting from the war effort. Other industries, on the other hand, have benefited in large measure from Government assistance in the form of loans for plant acquisition or expansion, capital recoveries through the prices charged for manufactured products, and/or rapid amortization. Much of the cost of plant construction and expansion in the munitions, aircraft, and shipbuilding industries has been provided by the Government. Depreciation of such plants is accordingly borne by the Government. In some instances, the plants constructed at the expense of the Government are leased to private concerns with the privilege of purchase at an appraised value at the termination of a 5 year period. In these cases, of course, the wear and tear of such plants is borne by the Government. None of these situations exists on the railroads.

POLICING OF DEDUCTION FOR DEFERRED MAINTENANCE

The Bureau of Internal Revenue should rely upon the reasonableness of the amounts of deferred maintenance authorized by the Interstate Commerce Commission to be accrued in the accounts of the railroads. The Commission is thoroughly acquainted with railroad affairs, and is constantly engaged in checking railroad accounts. However, the railroads will welcome the opportunity to supply whatever additional data may be required by the Bureau of Internal Revenue.

The engineering staffs of the railroads are thoroughly conversant with the traffic demands upon the railroad properties and the resulting need for maintenance and repairs. They will prepare estimates of the amounts required for maintenance and repairs for specific purposes in the same manner as they now customarily estimate the various items of railroad cost. Estimates of deferred maintenance prepared in such manner may be safely relied upon by the Commission in passing upon the reasonableness of the amounts of deferred maintenance sought to be accrued by the railroads.

The Commission in its order has required that railroad applications shall state full particulars respecting the nature of the repair work involved, and the estimated cost thereof, by primary accounts. The amounts of deferred maintenance authorized by the Commission will, therefore, be based upon a factual showing of specific work needed and planned for the current year not performed because of lack of material or labor or both.

Unless actually expended within the period specified in the suggested legislation, the amount thereof would be restored to income and taxed. When the expenditures are made and paid for out of the reserve, they will not be included as an operating expense in the year in which they are made. The method of deduction and adjustment provided in the suggested legislation thus in and of itself constitutes an effectual check upon the amount of deferred maintenance which will be taken as a deduction.

The CHAIRMAN. May I ask you whether this particular question was presented to the Ways and Means Committee?

Mr. FLETCHER. No, sir; it was not presented to the Ways and Means Committee. We had not then worked the thing out. At that time, Senator, when the hearing was had before the Ways and Means Committee, we did not have the approval of the Interstate Commerce Commission, in the matter, and that is a very important feature of it, you see.

The CHAIRMAN. Yes.

Mr. FLETCHER. Because the policing would be done by that body.

I would like also to put into the record our suggestion as to a draft of an amendment which would bring this about.

That is an amendment to section 125 (a).

The CHAIRMAN. You may do so.

(The amendment referred to is as follows:)

DRAFT OF PROPOSED AMENDMENT TO THE INTERNAL REVENUE CODE

SEC. 23 (v) DEFERRED MAINTENANCE DEDUCTION—RAILROADS.—The deduction for deferred maintenance provided in Section 125.

SEC. 125 (a) DEFERRED MAINTENANCE DEDUCTION—RAILROADS.—In computing net income of common carriers by railroad subject to the Interstate Commerce Act, as amended, there shall be allowed as deductions the amounts which any such common carrier shall have accrued in its accounts, upon specific authorization of the Interstate Commerce Commission, representing the estimated cost of maintenance and repairs which such common carrier finds itself unable in any taxable year to undertake or complete due to inability to obtain materials and supplies, shortage of labor, or adverse labor conditions, or other causes arising from the war emergency: *Provided*, That the amounts so deducted shall be evidenced by certificates of the Interstate Commerce Commission, copies of which shall be filed with the taxpayer's income-tax return: *And provided further*, That United States Treasury securities in the amounts so deducted shall be set aside and held in the taxpayer's treasury until utilized in settlement of charges incurred

for such maintenance and repairs or released in accordance with the provisions of paragraph (b) hereof.

(b) The deductions provided in paragraph (a) of this section may be availed of in any taxable year beginning after December 31, 1941, but may not be taken in any taxable year beginning after December 31 of the year in which the President shall issue his proclamation declaring the war ended by ratification of a treaty of peace or otherwise: *Provided*, That the amount by which the actual expenditures of the taxpayer for such maintenance and repairs, made within five years after December 31 of the year in which the President issues his proclamation, is less than the total deductions on account thereof, shall be included in the gross income of the taxpayer in the next succeeding taxable year and taxed at the rates applicable to the taxable year in which such deductions were allowed, under regulations prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, and a corresponding portion of the impounded United States Treasury securities released.

Mr. FLETCHER. I submit these drafts with a considerable amount of reluctance, because I know something about the excellence of the drafting service of the Congress, but possibly there might be some ideas there which would be of value to your drafting service.

Now, there is one other matter that I would like to submit—and I will hurry through these other matters.

Those are the two principal ones I wanted to discuss.

On this question of consolidated returns, the committee will remember that some years ago, upon representations made by representatives of the railroads, they were permitted—and the only industry I believe that was permitted—to make consolidated returns where there was an ownership of 95 percent of the total amount of the capital stock of the corporations entering into the system.

The reason why the railroads were allowed to do that and others were not was this, briefly: Railroads have to have these subsidiary corporations on account of State laws. If you take the State of Texas, for example, in Texas no railroad company can operate in that State unless it is incorporated under the law of that State. It has to have a general office in that State, and maintain a staff of employees there, so that they will be subject to all of the rules and regulations that apply to State corporations.

No railroad company, so far as I know, willingly and purposely has all of these various subsidiary corporations. It is done because the State laws require it. In my own State, that I lived in so long, in the State of Mississippi, there was a constitutional provision that foreign railroad corporations could not own a domestic railroad corporation, and a domestic corporation had to be owned by another corporation which was itself domestic in its nature.

By reason of the fact that these various subsidiary companies existed, not by the will and desire of the companies but in obedience to State law, they were allowed to make a consolidated return.

Now, this act, as it passed the House, you understand, allows all corporations to make a consolidated return, with which I have no quarrel, but it puts a 2-percent tax penalty upon those who select that method of making their returns.

We do not think that is quite fair in the case of the railroads who had to have these subsidiary corporations.

Senator BROWN. Two percent of the total amount of the tax?

Mr. FLETCHER. Two percent of the total amount of the tax, Senator.

For that reason, I respectfully suggest that in line 19, on page 104

of the bill, as it passed the House, there be added this provision, which I will quote into the record. It is very short.

Provided, however, That such 2-percent tax on the privilege of making consolidated returns shall not apply to railroad corporations, subject to the Interstate Commerce Act.

It does not seem to me that railroads should be penalized for something they cannot avoid.

Mr. Chairman, I want to say just one word about the provision of the House bill which requires employers to deduct 10 percent on wages, the so-called withholding provision of the act.

Whether that will be approved by the Senate Finance Committee and by the Senate, of course, I do not know; but I do say this provision, if it is applied to railroad companies, as it will be if it follows the form provided by the House, should be rewritten.

For instance, if you examine the complicated provisions of that part of the law which deals with withholding, you will find that the employer has got to find out about the married status of the employee, and how many children he has, in order to make the right amount of deduction.

Now, in the railroad business, we have lots of people who work only 1, 2, or 3 days at a time, because a big snow falls in Detroit or some other city in that section of the country.

The CHAIRMAN. They are excepted as casual workers.

Mr. FLETCHER. Are they entirely excepted?

The CHAIRMAN. I had that impression.

Mr. FLETCHER. I do not think they would be, Senator. I may be wrong.

The CHAIRMAN. I may be wrong.

Mr. FLETCHER. In any event, the railroad workers drift from place to place, and you have to keep all this detail about whether they are married or not, and whether they have dependents, and what should be the amount of the deduction.

Why not just put a straight tax on them? It may be a graduated tax according to their income, and let them settle with the Treasury later on.

They have to do that anyhow. The Treasury has got to examine the status of each one of these people.

It seems to me that is a burden that should not be put upon the employers, and I would like therefore to submit to the committee, if I may, without reading it, but putting it in the record, a proposed amendment to section 426 dealing with tax collected at the source, which provides for a sliding scale of 2 percent on payments up to $500, 4 percent up to $750, 6 percent up to $1,000 and so on. Of course, in the year 1943, when there is only a 5-percent tax, there would be just half of that amount.

(The amendment referred to is as follows:)

(a) REQUIREMENT OF WITHHOLDING.—There shall be withheld, collected, and paid (except in the cases provided for in section 143) upon all dividends, bond interest, and wages of every person, to the extent that such dividends, interest, and wages are includible in gross income, a tax equal to 10 per centum of (1) such dividends and interest, and (2) a tax equal to—

2 percent of each payment of wages in excess of $500 but not in excess of $750.

4 percent of each payment of wages in excess of $750 but not in excess of $1,000.
6 percent of each payment of wages in excess of $1,000 but not in excess of $1,500.
8 percent of each payment of wages in excess of $1,500 but not in excess of $4,000.
10 percent of each payment of wages in excess of $4,000.
except that, for the calendar year 1943, such tax shall be 5 per centum of such dividends and interest, and on each payment of wages tax shall be equal to—
1 percent of each payment of wages in excess of $500 but not in excess of $750.
2 percent of each payment of wages in excess of $750 but not in excess of $1,000.
3 percent of each payment of wages in excess of $1,000 but not in excess of $1,500.
4 percent of each payment of wages in excess of $1,500 but not in excess of $4,000.
5 percent of each payment of wages in excess of $4,000.

Senator GERRY. Do you have any estimates as to what it would cost the railroad to withhold the tax at the source?

Mr. FLETCHER. I could not give you a figure on that, Senator. It would be a mere guess. I know it would be an enormous burden however.

Senator GERRY. They could not even get the men to do it, could they?

Mr. FLETCHER. I am afraid that is true; I certainly think that is true because the field of clerical workers is running shorter all the time.

Mr. Chairman, I do think the change in the law about long-term capital losses is going to work a very great hardship.

You know, at the present time, under the act as it passed the House, long-term capital losses—and my understanding is it means capital obligations running over a period greater than 15 months—cannot be deducted, except they may be deducted as a credit against capital gains. In other words, before you can get any deduction for capital losses you have to have capital gains in an equal amount or a greater amount.

Here is the trouble, and it is peculiar of the railroad industry: We are now in a program of abandoning branch lines——

The CHAIRMAN. How is that?

Mr. FLETCHER. I say, we are engaged in a program of abandoning branch lines.

The CHAIRMAN. Yes, sir.

Mr. FLETCHER. We are urged by the War Production Board to expedite that program.

Some cases have happened where the steel which constitutes the rails on these branch lines has actually been seized by the Government without waiting for an abandonment order to be issued by the Interstate Commerce Commission. I do not mean they have seized any lines of very great importance.

Here is a constant urge by the War Production Board to let them have the steel which composes the roadbed, the rails in these branch lines which they need for the manufacture of the steel so essential to the war effort. If they are not allowed to write off the losses which

occur by the abandonment of these branch lines, it is going to make a very great hardship upon certain railroads.

Again many of these railroads are being reorganized as you know, and in the process of reorganization, the capital stock is being wiped out, and some of the railroads have investments in that capital stock of very considerable amounts. There again it seems to me that the present law should be kept in the form it is in, in order that these long-term losses may be taken in instances where the railroad company, the investor, is absolutely helpless.

The CHAIRMAN. You have no objection to breaking it into two brackets between short and long terms?

Mr. FLETCHER. No; only in preserving the right to have long-term losses deducted, as the law stands now.

The CHAIRMAN. I am very much inclined to think you are correct about that, as to all legitimate long-term losses.

Mr. FLETCHER. Legitimate long-term losses, capital losses.

The CHAIRMAN. Outside of the speculative group.

Mr. FLETCHER. That is right.

The CHAIRMAN. If you are going to have nothing but losses you are going to have nothing to charge them against.

Senator VANDENBERG. Especially if those losses are chargeable to Government orders.

Mr. FLETCHER. That is right. It amounts to that.

Mr. Chairman, in section 23 (q) of the code, corporations are allowed to make deductions for certain amounts which constitute contributions to charities.

The CHAIRMAN. Yes.

Mr. FLETCHER. I do not believe that law as it stands now would apply to contributions made for the United Service Organizations.

Mr. Chairman, I respectfully ask the committee to have someone look at that and see if it would not be a sound policy to permit such an amendment to that act as would permit railroads to make reasonable contributions to the United States.

They cannot make unreasonable ones, because that is governed by general principles of law anyhow, but they should be permitted to make reasonable contributions to the United Service Organizations and similar war activities.

Your attention is called to that feature.

The CHAIRMAN. We will be pleased to do that.

Mr. FLETCHER. With respect to freight transportation, there is a 10 percent tax on freight transportation. I understand that has been disapproved, so to speak by the Treasury, and that it is not favored by Mr. Henderson of the Office of Price Administration.

I express no view on the subject generally. If it is considered to be desirable and necessary to put that tax on freight transportation, the railroads of course will not pay it, but I would like to make just a suggestion or two.

I think the tax on coal should be stated in short tons instead of long tons. It is a 5-cent tax on long tons, which makes it very difficult, as an accounting matter.

In the second place, I would like to call your attention to a statement on page 318 of the act as it passed the House and to suggest

that in the second line on that page, after the word "express company" there be included the words "railroad company."

The effect of that amendment would be to prevent a double tax.

You know sometimes railroads have a pick-up and delivery service. They hire trucks, or they hire express companies to pick up and deliver, and the trucks deliver the freight. It is possible the law might be construed as putting a tax on the amount which the railroad companies pay to these truckers for performing that pick-up and delivery service.

An effort has been made, you notice by looking at page 318 of the bill, to prevent that double taxation, and I think it would be well to insert the words "railroad company" after the words "express company" in the second line.

I also call your attention to the fact that in the War Revenue Act of 1917, in putting a tax upon freight transportation there was an exemption made in the case of freight moved by a subsidiary of the railroad to another railroad company in the same system.

I should like to ask the reporter to quote at this point the provision of the War Revenue Act of 1917 which exempted from the tax the transportation of materials moving by a carrier for the conduct of its own business, and also transportation of company material generally.

(The provision of the act referred to is as follows:)

Provided further, That nothing in this or the preceding section shall be construed as imposing a tax (a) upon the transportation of any commodity which is necessary for the use of the carrier in the conduct of its business as such and is intended to be so used or has been so used; or (b) upon the transportation of company material transported by one carrier, which constitutes a part of a railroad system, for another carrier which is also a part of the same system.

Mr. FLETCHER. Mr. Chairman, I have just one more word to say. As I have said before, we have about one-third of the mileage of the railroads of the country in bankruptcy.

I have a list of those bankrupt railroads here. If you would like to see it put in the record, I could do so, but I presume it is hardly necessary at this time.

Senator CONNALLY. May I ask you a question right there?

Mr. FLETCHER. Yes, Senator.

Senator CONNALLY. What percentage of the railroads in bankruptcy is there in which the owners of the bonds are also substantially the owners of the stock?

Mr. FLETCHER. Very few; very few. On the reorganization, they ought to be the owners of the stock.

Senator CONNALLY. I mean before that.

Mr. FLETCHER. No; I do not think there is much of that.

Senator DAVIS. I would suggest you list them in the record.

Mr. FLETCHER. I would be glad to put them in the record. At this time I offer for the record a list of the railroads that are now undergoing reorganization, either in equity receivership or under section 77 proceedings.

(The list of railroads referred to is as follows:)

Class I railways in the hands of receivers and trustees, excluding switching and terminal companies, Mar. 31, 1942

	Miles of road operated Dec. 31, 1940
In receivership:	
Ann Arbor	294
Georgia & Florida	408
Minneapolis & St. Louis	1,400
Pittsburgh, Shawmut & Northern	190
Rutland	407
Seaboard Air Line	4,310
Total (6 roads)	7,018
In trusteeship:	
Akron, Canton & Youngstown	171
Central of Georgia	1,864
Central R. R. Co. of New Jersey	711
Chicago & North Western	8,819
Chicago, Indianapolis & Louisville	549
Chicago, Milwaukee, St. Paul & Pacific	10,854
Chicago, Rock Island & Pacific	7,909
Denver & Rio Grande Western	2,506
Duluth, South Shore & Atlantic	550
Florida East Coast	685
Gulf Coast Lines:	
Beaumont, Sour Lake & Western	146
New Orleans, Texas & Mexico	191
San Antonio, Uvalde & Gulf	317
St. Louis, Brownsville & Mexico	602
International-Great Northern	1,155
Minneapolis, St. Paul & Sault Ste. Marie	4,267
Missouri-Illinois	139
Missouri Pacific	7,146
New York, New Haven & Hartford	1,853
New York, Ontario & Western	576
New York, Susquehanna & Western	144
St. Louis-San Francisco	4,769
St. Louis Southwestern	1,003
St. Louis Southwestern of Texas	644
Western Pacific	1,199
Total (25 roads)	58,377

Mr. FLETCHER. Now these railroads, Mr. Chairman, have had a very serious tax problem before them. They cannot emerge from bankruptcy unless they get some relief on this question of taxes. They are going to have their capital obligations tremendously scaled down as the result of the bankruptcy proceedings.

If you are going to have to put a tax at the very severe rates—which apparently the Congress is going to have to impose upon all corporations—upon the difference between their old capitalization and their new capitalization, they start out bankrupt, they are busted, to use the common expression, before they leave the starting point.

Now, in addition to that it is absolutely essential that these railroads should preserve their old capital basis for the purpose of calculating the excess-profits tax.

If they are to take the new capital basis they are in the excess-profits-tax class before they start again.

So that the carriers which are now in reorganization, one-third, as I said, of the mileage of the country, if they are not permitted to have some form of relief here, why they never will be able to emerge from bankruptcy and get upon a sound position. They have got to preserve the basis of their property, and the reorganizations must be tax-free.

This question has been discussed with the Treasury at considerable length. As those gentlemen who work in the Treasury—worked with us at least—are always considerate, always patient, and always intelligent, they have considered these suggestions, and we are very hopeful that we will be able to agree with them, if the Congress will agree with both of us, as to the character of legislation which is desirable to enable these bankrupt roads to come out of bankruptcy and get started on their own.

Again I ask the privilege of filing with the committee a memorandum here, which is the joint product of the Association of American Railroads and the Railroad Security Owners Association in which this subject is very fully discussed and the character of amendments which the railroads desire is set out in the memorandum.

May I file it if it is not too long, Mr. Chairman?

The CHAIRMAN. You may put it in the record.

(The memorandum referred to is as follows:)

FEDERAL TAX PROBLEM OF RAILROADS IN REORGANIZATION, A MEMORANDUM SUBMITTED BY ASSOCIATION OF AMERICAN RAILROADS AND RAILROAD SECURITY OWNERS ASSOCIATION, INC., WASHINGTON, D. C., AUGUST 27, 1941

TAX PROBLEMS OF RAILROADS IN REORGANIZATION

About 75,000 miles of railroad are now in the hands of the courts in reorganization proceedings, including some 15 of the major carriers. These roads, as public service corporations, are expected to continue to play their full part in a strong, well-managed, and ample transportation system for the country. Through the courts and Interstate Commerce Commission, railroad reorganizations are presumed to be effected for the dual purpose of assuring efficiency of operation and greater stability in railroad investments—scaled down as these investments are in reorganizations to represent sound capitalization.

It cannot have been contemplated by the public or the Congress that by such reorganization the tax contributions of the railroads should be increased—increased indeed, to an amount quite out of proportion to the contributions of the other railroads which are already carrying as full a share of the Nation's tax burden as it is economically wise to impose. Yet that very result will follow under existing law as now administered unless the Congress enacts remedial amendments.

The existing provisions of the Internal Revenue Code, as they are being applied to a reorganized railroad, so reduce the taxable basis of its property as to create for it taxable income for normal and excess-profits taxes which will be very much greater than would be the case if it were not reorganized, though it continues with the very same property and with the very same revenue. Obviously such a result not only operates to defeat the sound purposes of reorganization but jeopardizes the future credit of the company upon which depends the maintenance of the property and the services essential to the public welfare.

It may go even further. The diversion to taxes of a much greater proportion of the net income necessarily will increase the reluctance of security holders to accept such drastic reductions in their securities, and may in some cases prevent entirely the consummation of the pending plans. Certainly there will be no incentive to effect early and prompt reorganizations.

This memorandum is intended to set forth the anomalous tax situation above referred to, and to suggest amendments to the pending revenue bill which will reasonably correct that situation.

I. Increased Federal taxes resulting from decrease in deduction for interest charges

The first item of the increased tax burden results from the fact that in all pending reorganizations the amount of fixed and contingent interest charges has been substantially reduced. The immediate effect on a reorganized carrier is that the amount of deductions which it may claim for these payments has been correspondingly reduced, and its normal income and surtax charges correspondingly increased. For instance, a carrier in reorganization has old fixed charges aggregating $14,000,000. With an income of $20,000,000 in 1941, its normal income tax and surtax would be 30 percent of approximately $6,000,000, or $1,800,000. If its fixed charges were reduced to $5,000,000, its normal and surtaxes on the 1941 basis would be 30 percent of approximately $15,000,000, or about $4,500,000.

It must be presumed that the Interstate Commerce Commission takes cognizance of this situation in prescribing the new capitalizations, and that the benefit to the carriers of having a substantial debt reduction offsets the disadvantage of having to pay a greatly increased normal tax. No legislation is suggested with respect to this matter.

II. Possible reduction in basis of property

Section 112 (g) of the Internal Revenue Code, which defines "tax-free" reorganizations, is not broad enough under present interpretations of the Bureau to include all railroad reorganizations, as a result of which a reorganized railroad might be held to have a reduced basis for its property. Furthermore, under the present law, a cancelation of indebtedness incident to a reorganization may be held to be income; if so, the reorganized carrier must either pay (which none could do) the resulting income taxes on the amount of the debt reduction or may consent to a reduction in its basis of property in conformity with the pertinent regulations.

Such interpretations of the present law by the Bureau will operate in two ways, both to the disadvantage of the reorganized carrier, as compared with the solvent carrier.

1. Decrease in deductions for depreciation and retirements.—In computing its taxable income, the carrier is entitled to deductions for depreciation and retirements. These deductions are at present computed on the basis of original cost of the property. If the basis of property is reduced, the allowable deductions for depreciation and retirements will be correspondingly reduced to amounts that will be substantially less than similar allowances for a solvent carrier, and less than required by the Interstate Commerce Commission as a basis for the statement of net income. The decrease in allowable deductions for depreciation and retirements will result in increased taxable income.

To illustrate: On a property of which the original cost is $500,000,000, the retirement and depreciation deductions for tax purposes may be $5,000,000. If the basis of property is reduced to $200,000,000, these allowable deductions will be proportionately reduced to two-fifths of $5,000,000, or $2,000,000. Two carriers with the same income from operations will have different taxable incomes, and the disadvantage will be with that carrier which has been reorganized.

The Interstate Commerce Commission has recognized this inequity so far as its own accounting rules are concerned. In the *Chicago Great Western case, Ex Parte 138*, it prescribed regulations which require a carrier as reorganized to show on its new books the original cost as a "basis of property." This basis is to be used for determining depreciation charges and retirement losses, maintenance costs, capital expenditures, fixed and contingent charges earned, and availability of funds for dividends or other purposes,[1] upon which

[1] The following excerpts from the Commission's opinion in the *Great Western case* reversing the order of division 1 establish this point:

"With respect to property other than equipment and subject to retirement accounting, the effect of the accounting proposed by division 1 would be somewhat different. Such property would be carried in the primary investment accounts, under the distribution plan assumed above, at amounts very materially below its original cost. Upon retirement of any unit which is replaced, therefore, operating expenses would be charged with such a low amount. On the other hand another railroad operating in the same territory which had managed to escape bankruptcy and reorganization would upon retiring a comparable property unit, charge operating expenses with the full original cost. The one railroad would

recipients of interest and dividends are required to pay their income taxes.

2. Decrease in invested capital credit for excess-profits taxes.—In cases now pending in the Internal Revenue Bureau, its findings indicate that the new basis of property will be determined by reference to the market value of all or part of the reorganized company's securities. Application of the market value method would also decrease the invested capital credit for the purpose of computing excess-profits taxes. This would further increase the disproportionate burden of taxes payable by the reorganized carrier, with results as shown below.

III. Illustration

For purposes of simplicity and equitable comparisons no allowance has been made in the following illustrations for any effect of the excess-profits credit carry-over under section 710 (c). The specific exemption of $5,000 allowed by the statute in arriving at adjusted excess profits net income and the item of inadmissible assets have also been ignored for reasons of simplicity.

Assume two railroads—A and B—each having the same original cost of $600,000,000 ($500,000,000 road and $100,000,000 equipment) and each having $50,000,000 of equipment depreciation reserve, and now capitalized as follows:

Debt	$300,000,000
Stock	200,000,000
Surplus of road A or unpaid accumulated interest of road B	50,000,000
Total	550,000,000
Earnings from operation in 1941	20,000,000
Annual fixed charges	15,000,000
Annual retirement charges ($3,000,000 less $1,000,000 already included in operating expenses)	2,000,000
Net taxable income	3,000,000

Railroad A is not reorganized; railroad B is reorganized under section 77 of the Bankruptcy Act. Its new capitalization, approved by the Commission and the courts, is as follows:

Debt	$125,000,000
Stock	200,000,000
Total	325,000,000
Earnings from operation in 1941	20,000,000
Fixed and contingent interest charges	6,000,000
Retirements deductible on basis of original cost	2,000,000
Net taxable income if retirement deductions are allowed on present base	12,000,000

If the reorganization should be completed during 1941, a comparison of the taxes to be paid by these roads on the basis of the tax rates provided in the 1941 revenue bill as passed by the House, but ignoring the special 10-percent tax on corporations with low base period incomes, is as follows:

Total income and excess-profits taxes:	
Road A	$899,750
Road B after reorganization	8,264,650

have a lower operating expense than the other, but thereby less cash would be reserved from revenue which could be used for the replacement of the unit. A considerable part of the cost of replacement would be capitalizable and might require the issue of new securities. *Also taxes on income would be increased as the result of the reduced operating expenses.*"

* * * * * * *

"What has already been said shows, we believe, the *advantages of a uniform and continuing basis* for the depreciation and retirement charges on account of railroad property, regardless of whether the accounting company has or has not undergone financial reorganization or whether it has acquired units of property new or as parts of going concerns. The fact that if such charges were based on original cost rather than on depreciated value, they would, in a case like this, more nearly approximate the replacement cost, is an important element in these advantages." [Italics supplied.]

The details are as follows (it is believed that the illustrations chosen approach actual facts in the case of several of the companies):

ROAD A

(1) Excess-profits tax:		
Invested capital will be—		
(a) One-half of debt		$150,000,000
(b) Capital stock and surplus		250,000,000
Total		400,000,000
Invested capital credit:		
8 percent of first $5,000,000	$400,000	
7 percent of $395,000,000	27,650,000	
		28,050,000
Excess-profits tax		None
(2) Normal and surtax:		
Net taxable income		3,000,000
Normal tax—24 percent		720,000
Surtax:		
5 percent on first $25,000	$1,250	
6 percent on $2,975,000	178,500	
		179,750
Total taxes		899,750

ROAD B

The Bureau of Internal Revenue in cases now pending has indicated an intention of computing the basis of property by reference to the face amount of the reorganized company's debt plus market value of its issued stock, and without reference to the original cost basis established by the Interstate Commerce Commission in the *Great Western case*. Assuming an average market value of 15 for the new stock of the reorganized road B, which is a liberal estimate, its basis of property will be $155,000,000.

In such case, the taxes of road B will be as follows:

(1) Excess profits tax:		
Invested capital will be—		
(a) One-half of debt		$62,500,000
(b) Capital stock at market value		30,000,000
Total		92,500,000
Invested capital credit:		
8 percent on first $5,000,000	$400,000	
7 percent on first $87,500,000	6,125,000	
		6,525,000
Earnings available for charges in 1941		20,000,000
One-half of fixed and contingent interest charges	$3,000,000	
Retirements of $2,000,00 reduced in proportion to reduction of $395,000,000 in present $500,000,000 original cost basis of road and structures (no adjustment has been included herein for retirements charged to operating expenses, which may be assumed to amount to $1,000,000)	420,000	
		3,420,000
Excess profits net income		16,580,000
Less—credit		6,525,000
Adjusted excess profits net income		10,055,000
Excess profits tax ($254,000, plus 60 percent of excess over $500,000)		5,987,000

(2) Normal and surtax:		
Excess profits net income		$16,580,000
One-half of fixed and contingent interest charges	$3,000,000	
Excess profits tax	5,987,000	
		8,987,000
Normal and surtax net income		7,593,000
Normal tax—24 percent		1,822,320
Surtax:		
5 percent on first $25,000	$1,250	
6 percent on $7,568,000	454,080	
		455,330
Total normal and surtax		2,277,650
Total taxes		8,264,650

This tax of $8,204,650 payable by road B is $7,364,900 greater than the tax payable by road A. The earnings from operation, before taxes, are $20,000,000 in the case of each road. The original cost of each property is still the same, $600,000,000.

In an industry so thoroughly regulated, this disparity is manifestly unjust.

IV. An actual case

The foregoing figures are used for illustration. They are based on the rates contained in the pending revenue bill. In the following illustration the computations are made on the basis of the rates in the 1940 act, except that a normal tax rate of 30 percent is used, instead of 24 percent.

One of the largest of the railroads now in bankruptcy will report approximately $21,000,000 as earnings available for fixed charges in 1941 before any deduction for Federal-income taxes (if present upward trend continues, actual earnings may exceed this). If this railroad company were not undergoing reorganization, earnings to the amount of $21,091,000 would be used to pay fixed charges of $16,591,000 and absorb estimated retirement charges of $4,500,000 not included in operating expenses, or a total of $21,091,000 as proper and legitimate deductions in arriving at taxable income. Thus there would be no Federal normal income tax nor any excess-profits tax.

As a result of reorganization, the position of the company with respect to income taxes with these same earnings of $21,091,000 available for fixed charges would be much different. The effect of the reorganization is to reduce fixed charges of $16,591,000 to fixed charges and contingent interest of $9,043,000. This reduction of $7,548,000 would become taxable income of the company, which but for reorganization would be nontaxable. At the rate of 30 percent the normal tax thereon would be $2,264,000. Thus it is seen by reason of the reorganization the company will pay much greater taxes. The security-holders have suffered heavy losses and will suffer further by the heavy taxes exacted from the reorganized company as the result of the scaling down of fixed charges.

There is a justifiable fear that, unless there is clarifying legislation, the tax burden may be even greater than outlined above.

A recent ruling by the Bureau of Internal Revenue for another railroad which was reorganized this year holds that the tax basis of the reorganized property should be the par value of the liabilities plus the fair market value of the stocks of the reorganized company. Applying this ruling to the case in question, the tax basis would be approximately $323,000,000 representing a total of $205,000,000 bonded debt, $106,000,000 other liabilities and credits and $11,827,000 market value of stock. The latter was computed by using recent market prices of $7.88 per share for 1,060,961 shares of new preferred stock and $3.15 per share for 1,077,998 shares of new common stock. This constructed tax basis of $323,000,000 compares with the present tax basis on an original cost basis of $798,000,000, or a reduction of $475,000,000.

It is reasonable to assume that the present tax basis for equipment amounting to $151,000,000 and for current assets would remain undisturbed. Also since there has not been a determination of the write-down to be made in this com-

pany's security investments of $78,000,000, it is assumed the entire reduction of $475,000,000 in the tax basis would be applied to the present tax basis of $489,000,000 in road and structures. This would cause a reduction of 97.4 percent in the tax basis of such property. Admittedly, the resulting tax base of $14,000,000 for road and structures compared with its original cost of $489,000,000 is so unrealistic as to be absurd, but it is necessary to make this illustration to show the tax consequences. While the reduction of 97.4 percent shown above is caused by applying the entire write-down of $475,000,000 against road and structures, if the entire security investments of some $78,000,000 were arbitrarily written off, the balance of the required write-down would be $397,000,000. Applying this reduction of $397,000,000 to road and structures with an original cost of $489,000,000, the resulting percentage decrease would be about 80 percent. Thus, the change on this most conservative basis would still be fantastic.

Retirement charges in 1941 for property other than equipment are estimated to be $900,000 chargeable as operating expenses and $4,500,000 chargeable to profit and loss, or a total of $5,400,000. The amount of these charges is based on original cost as prescribed by the Interstate Commerce Commission in the Chicago Great Western opening entries (*Ex Parte* 138) decision. If the tax basis of this property is reduced 97.4 percent, the retirement charges of $5,400,000 which the company is presently entitled to deduct in determining taxable income would be reduced by 97.4 percent or by $5,260,000. Thus taxable income would be increased by this amount. (If the reduction in retirements were made at the rate of 80 percent, the resulting increase in taxable income would be $4,320,000 instead of the $5,260,000 shown in the preceding sentence. The elimination of the difference of $940,000 from taxable income would reduce the total normal and excess-profits taxes by $611,000, which would appear to be the maximum amount by which the tax burden used in this illustration might be overstated.)

This $5,260,000 would be taxable income created solely by reason of the reduction in the tax basis and the income tax thereon at 30 percent would be $1,578,000. When this tax is added to the $2,264,000 tax which will result from the lower interest charges of the reorganized company, the total normal income tax resulting from the reorganization would be $3,842,000 in contrast to no income tax if the company had not undergone reorganization. The magnitude of the $3,842,000 tax may be better sensed when it is realized it is equal to almost 25 percent of the old fixed charges and it exceeds the reorganized company's new fixed charges of $3,053,000.

In addition to the foregoing substantial increase in the normal income tax, this railroad reorganized would be exposed to a large excess-profits tax if the Bureau determined invested capital by including equity capital at market value. Under the market value theory, the excess-profits tax for 1941 would be about $2,000,000, assuming an 8 percent credit basis and assuming a normal income tax rate of 30 percent. This tax would be greater if the tax bill as passed by the House, which reduces the credit to 7 percent, becomes law.

Summarizing, there is shown below the probable tax consequence for 1941 for this particular railroad, which it will be noted would have had to pay no income or excess-profits taxes on estimated 1941 income with its old capital structure. But this same enterprise and investment continuing to be devoted to the public service and with the same earnings would have to pay to the Federal Government $5,842,000, or 28 percent of its relatively low income. This tax is equal to 4 percent on approximately $146,000,000.

The original cost of road and equipment in this case is approximately $640,000,000. A fair return on this amount would be approximately $32,000,000. The earnings for 1941, before taxes, of $21,091,000, is a return of only 3.3 percent on the original cost. After deduction of the taxes of $5,842,000, the remaining earnings would be $15,249,000, or less than 2½ percent on the original cost.

Present company

Income available for fixed charges		$21,091,000
Fixed charges	$16,591,000	
Retirement losses	4,500,000	
Total deductions		21,091,000
Taxable income		None
Normal income tax		None
Excess-profits tax		None

Reorganized company—with no change in tax basis

Income available for fixed charges (before income taxes)		$21,091,000
Fixed charges and contingent interest	$9,043,000	
Retirement losses	4,500,000	
Total deductions		13,543,000
Taxable income		7,548,000
Normal income tax at 30 percent		2,264,000
Excess-profits tax		None
Total normal and excess-profits tax		2,264,000

NOTE.—No objection is made to this tax.

Reorganized company—with tax basis reduced as explained above

Income available for fixed charges (before income taxes)		$21,091,000
Increase in above income resulting from reductions of 97.4 percent in $900,000 retirement charges included in operating expenses		877,000
Restated income available for fixed charges		21,968,000
Fixed charges and contingent interest	$9,043,000	
Retirement losses of $4,500,000 reduced 97.4 percent	117,000	
Total deductions		9,160,000
Taxable income		12,808,000
Normal income tax at 30 percent		3,842,000
Excess-profits tax (8 percent credit basis)		2,000,000
Total normal and excess-profits tax		5,842,000

As indicated above, the foregoing computations are based on the 1940 act, with the exception of the normal tax rate having been changed from 24 to 30 percent. (An application of the tax rates in the pending bill, as used for road B in the preceding illustration, would result in a tax of about $7,624,000.)

It should be repeated that no objection is raised to the increased taxes of $2,264,000 included in the $5,842,000 resulting from reduced interest charges but the balance of $3,578,000 resulting from the change in the tax basis should be eliminated by legislation.

Changes in the plan, decisions of the courts, or rulings by the Bureau may, of course, affect the above illustrations.

V. Proposal

The proposal of the reorganized carriers and of the security owners is that the law be amended to provide that the basis of property shall not be reduced below the original cost basis approved by the Interstate Commerce Commission under the accounting rules prescribed in the *Great Western case.* A draft of proposed amendments is attached hereto as an appendix.

Respectfully submitted.

ASSOCIATION OF AMERICAN RAILROADS,
RAILROAD SECURITY OWNERS ASSOCIATION, INC.

APPENDIX

Proposed amendments

Section 113 of the Internal Revenue Code should be amended, applicable to all taxable years beginning after December 31, 1938, by adding at the end thereof the following new subsection:

"(c) *Reorganization of common carrier by railroad.*—Notwithstanding the provisions of subsections (a) and (b) of this section and the provisions of section 114, the basis of property of a common carrier by railroad shall not be increased or decreased as a result of any judicial reorganization; and where in any such reorganization one or more new corporations are organized and pursuant to such plan of reorganization acquire property of such com-

mon carrier, the basis of such property to the new corporation or corporations shall be the same as the basis of such property would have been to the old corporation had there been no such judicial reorganization."

Section 112 of the Internal Revenue Code should be amended, applicable to all taxable years beginning after December 31, 1938, by adding at the end thereof the following new subsection:

"(l) *Reorganization of common carrier by railroad.*—No income, gain, or profit shall, in respect to the adjustment of the indebtedness of any railroad corporation in any judicial reorganization, be deemed, under any law of the United States of of any State now in force or hereafter enacted, to have accrued or to have been realized by such corporation, or any successor or successors in such reorganization, by reason of the modification or cancelation in whole or in part of the principal or interest of any such indebtedness of such corporation."

Mr. FLETCHER. I am very hopeful we may be able to reach a conclusion with the Treasury.

May I say that a certain gentleman here, Mr. Shorb, who expects to appear before this committee a week from today, upon another matter, would probably like to have an opportunity to say a word on the tax problem of the reorganized railroads.

The CHAIRMAN. All right.

Mr. FLETCHER. I thank the committee very much for your patient attention, and unless there are questions, I shall retire.

The CHAIRMAN. I wanted to ask if Mr. Wheeler is here.

Mr. FLETCHER. Mr. Harry A. Wheeler, of Chicago, is the president of the Railway Business Association. He was the first president of the Chamber of Commerce of the United States. In my humble judgment, he is one of the great economic statesmen of the country. He expected to be here. I wrote him that this would be his day. I do not see him in the room, and I am inclined to think that there must be some misunderstanding.

I am very hopeful that the committee might give him a few minutes, 10 minutes, say, at some later date, if they possibly can, provided he desires to appear.

The CHAIRMAN. He may appear later today.

Mr. FLETCHER. No, Senator; what he probably wanted to discuss was this deferred-maintenance question that I discussed secondly in my remarks.

We have here a representative of the Great Northern Railroad, Mr. Dorety. He would like 5 minutes to discuss a certain special point.

Would you permit me to distribute to the committee this technical discussion on the deferred-maintenance proposition? I have a number of copies.

The CHAIRMAN. Yes, sir; we will be glad to have you distribute them.

(The following statements were submitted by Mr. Fletcher:)

STATEMENT BY MARCUS L. BELL, GENERAL COUNSEL, THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY CO., CHICAGO

TAX PROBLEM OF REORGANIZED RAILROADS

The tax problem of the railroads now undergoing reorganization results from the mere impact of the existing revenue laws on their new capital structures. The memorandum of August 27, 1941, prepared by the Association of American Railroads and the Railroad Security Owners Association, states the problem in a general way. It contains, on page 13, two suggested amendments to the Internal Revenue Code.

The necessity for the adoption of these or similar amendments is emphasized by recent decisions of the Supreme Court concerning reorganizations of business corporations. From these decisions it may be deduced that none of the pending plans for the reorganization of railroads under section 77 is "tax-free" under the present laws. It follows that in the case of a reorganized railroad the new company which takes over the property will encounter immediately a situation which, unless the law is amended, will treble or quadruple the tax burden which the property will have to bear.

A part of this increase in taxes results from the fact that the new company's funded debt has been reduced, and it will have less interest to pay, and, therefore, a greater net taxable income; but one of the purposes of a reorganization is to reduce the amount of interest charges which the property must support, so that this result is inherent in the situation and is not due to any defect in the tax laws. The great—and, we submit, unjust—tax increase results from the fortuitous circumstances that the new company's "basis of property" will have been reduced in the reorganization process. The basis of property is the base upon which must be computed the amount of depreciation and retirements which are deductible in determining net income for tax purposes; and it is the starting point for the computation of the excess-profits tax.

Consider first the effect on depreciation and retirement charges of a reduction in the tax basis. The basis of property generally for any corporation is the cost of the property to the corporation. In the case of railroad companies, it is the cost as shown on their books—the investment account. If, as part of a reorganization plan, the property is sold to a new company, then the basis of property for the new company, under the present laws, is what the new company pays for it, either in new securities or cash, or both.

All the reorganization plans heretofore certified by the Commission involve a substantial reduction not only in the interest-bearing debt, but also in the total capitalization. The maximum that the new company, under the present laws, can be held to have paid for the old company's property is the total par value of the new securities. It is much more likely that it will be held that what the new company has paid for the old company's property is not the face or stated amount of the new securities issued for the acquisition of the property, but the current value of those securities; which means merely the par value of the new debt—that is, of the bonds of the new company, plus only the market value of the new stock. In either case, there would be a very substantial reduction in the basis of property.

If, on the other hand, the Commission approves a plan of reorganization which does not involve the formation of a new company, but allows the old company to continue in the ownership of its property, with a much reduced capitalization, then the old company meets the same problem in a different form. Its debt has been substantially reduced. If the total capitalization is not reduced, the conversion of old bonds into stock is only a capital exchange, and the tax basis is not affected by it; but if the total capitalization is reduced, then it probably will be held that this reduction in debt is income at least to the amount of the reduction in total capitalization and on this income the company must pay an income tax, unless it consents to a reduction in its basis of property equal in amount to so-called income resulting from the transaction.

In either case, the reduction in the basis of property will entail a very substantial reduction in the allowances which the Bureau of Internal Revenue will make for depreciation and retirements. These allowances will be reduced in the same proportion that the basis of property has been reduced. As stated in the memorandum of August 27, 1941, referred to above, the Interstate Commerce Commission in the *Chicago Great Western case* has recognized the inequity of this by permitting the new company to include in its balance sheet certain accounts which preserve a record of the actual investment in the property on the basis of original cost, whether made by the accounting company or its predecessor. In its opinion in that case (247 I. C. C. 193), the Commission points out that this practice is followed by the Federal Communications Commission and by the Federal Power Commission. Under the Commission's ruling, the new company charges its depreciation and retirement against this original cost as stated on the books of the old company.

But the deductions permitted by the Bureau of Internal Revenue for depreciation and retirements are altogether separate and distinct from the depreciation which is set up on the books under the Interstate Commerce Commission's accounting rules. The Bureau considers that it is not bound by the amounts

charged on the books under the accounting rules, and computes its depreciation allowances on an entirely different basis. If, therefore, the property base of road A, in reorganization, is cut in two, the depreciation and retirement charges allowed by the Bureau as a deduction in computing taxable income will be revised in the same proportion; whereas the deduction allowed to road B, not in reorganization, will continue unchanged. The tax burden of road A will be relatively higher than the tax burden of road B. Solely by reason of the fact that it has undergone what the Congress in framing section 77, and the Commission in administering it, have thought to be a desirable rejuvenation, its tax burden has been increased, as compared with its unregenerated competitors. Road A's credit has been impaired, and its securityholders, having suffered already a heavy loss in their capital through the reorganization, are faced with a further loss in the income on their new securities. They are further than ever from the realization of a return on their investment.

At present the Interstate Commerce Commission requires depreciation to be charged only against equipment, but beginning in 1943 similar charges will be made applicable to the greater part of the fixed structures. There is no difference, so far as the Interstate Commerce Commission's depreciation accounting is concerned, between road A and road B. From an accounting standpoint the bridges, buildings, freight cars, and locomotives of the Rock Island depreciate at the same rate and for the same reasons that similar items depreciate on the Santa Fe or the Burlington, and the Interstate Commerce Commission recognizes this fact. After the Rock Island reorganization is completed, however, and its basis of property thereby reduced, there will be a substantial difference, so far as the Treasury is concerned, in the depreciation charges allowable to the Rock Island as compared with its unreorganized competitors.

Inevitably, the Rock Island, or any other road in similar circumstances, will suffer a large increase in its taxes by reason of the smaller allowances for depreciation and retirements. This increase, added to the increase resulting from the minimizing of interest deductions, is almost enough to overload the new ship before it begins its voyage. It certainly puts the new company at a disadvantage as compared with its old neighbors.

But this is only the beginning. It is when we come to the excess-profits tax that we can appreciate the real burden resulting from a reduction of the tax base. Under the present law, the excesss-profits tax may be computed upon either of two bases. The railroads generally use the so-called invested-capital base. This term is a misnomer. "Invested capital" in the colloquial sense means one thing; but in the tax laws it is an arbitrary figure derived by adding 50 percent of the corporation's debt to the "equity invested capital" which, in general, may be considered as the sum of the capital stock and the surplus. It, therefore, is not the same as the basis of property, but, if the basis of property is reduced, "invested capital" will be correspondingly reduced, because both of its components (50 percent of the debt and "equity invested capital") will be reduced.

The "invested-caiptal credit," which is deducted before computing excess-profits taxes, is a certain percentage of this "invested capital." Under the proposed bill it is 8 percent on the first $5,000,000, 7 percent upon the next $5,000,000, then 6 percent on the remainder up to $200,000,000, and 5 percent on the excess. Deducting the invested-capital credit, the remainder of the income is called "excess profits," and is taxed at very high rates, the rate under the proposed bill being 90 percent. Under the present law, "invested capital" of the new company after reorganization will be computed on the basis of the new capitalization. If "invested capital" should be computed on the same basis for the new company as is proposed with respect to the "basis of property" (the new debt plus the market value of the new stock), then the new ship would be sunk before it left the harbor.

The effect of the present laws on the pending reorganizations may be illustrated by a reference to the Rock Island. I use that illustration because I am familiar with it. It is typical, however, of the other cases.

The present capitalization of the Rock Island is approximately $452,000,000, composed of approximately $322,000,000 of debt and $130,000,000 of stock, with interest charges of about $14,000,000 a year. Its property base is substantially in excess of that figure. Its investment account is in excess of $500,000,000. The value of its properties, computed under the Federal Valuation Act, at the present time is in excess of $460,000,000.

The present "invested capital" used for the computation of the excess-profits tax, being half of the present debt plus the total of the present stock, is $289,700,000, and the "invested capital credit" of the present company at the rates proposed in the bill is $16,648,361. This means that, until the earnings exceed $16,648,361, there will be no excess-profits tax to pay.

It is expected that the earnings available for interest charges, taxes, and dividends, if any, during the current year will be $24,140,780. This is the best estimate the accounting department can make at this time. It is based on the actual figures for the first 6 months of the year and the estimated figures for the final 6 months. On the basis of the present capitalization, the Federal income taxes on these earnings, computed at the rates embodied in the revenue bill as it passed the House, will be $3,506,160. This is because the deductions for interest and retirements will aggregate some $16,300,000. A statement showing how this amount is computed is attached hereto as exhibit 1.

This brings us to a consideration of the effect of the taxes on the plan of reorganization now pending in court. One of the primary purposes of any reorganization plan is a reduction of interest charges.

The Interstate Commerce Commission in certifying a plan to the district court estimated that the normal earning power of the system on gross revenues of $100,000,000 would be $11,000,000 above operating expenses. It fixed a maximum capitalization of $368,000,000, a reduction of $84,000,000. It held that the preferred and common stocks of the old company were without equity, and prescribed a new capital structure consisting of approximately $61,000,000 of fixed interest-bearing obligations, or 16.8 percent of the total; $80,000,000 of income bonds, or 21.7 percent of the total; $75,000,000 of preferred stock, 20.3 percent of the total; and $151,000,000 of common stock, 41.2 percent of the total. The total funded debt, $141,000,000, amounts to 38½ percent of the new capitalization; the total stock, $226,000,000, to 61½ percent. The requirements for interest charges are about $5,000,000; the sinking funds are $600,000, a total of approximately $6,500,000. In addition, the new company is required, before the payment of interest on the $80,000,000 income bonds, to set aside each year as a capital fund an amount equal to 2 percent of the gross operating revenues for the preceding year, up to a maximum of $3,000,000. From this it will be seen that the total capitalization has been reduced $84,000,000. The total debt has been reduced from $322,000,000 to $141,000,000, a difference of $181,000,000; and the total interest charges from $14,000,000 to $6,000,000.

The new company is required under the plan to provide from earnings only $9,500,000 a year for interest, capital, and sinking funds, prior to the stockholders' right or expectation to receive dividends.

But this is before taxes are computed. When we figure out the taxes under the present law, we see that the vision of dividends, or even of interest on the proposed income bonds, is illusory: The reorganization is a vain thing.

Under the plan the present stockholders are eliminated, so that it will be necessary to form a new company to take over the properties. The "basis of property" to the new company will be what the new company has paid for the old company's property; it is quite likely to be the face value of the new debt, plus the market value of the new stock. No one knows exactly what this will be, but if it is $10 or $15 a share (which is a liberal estimate of the prices at which such securities are sold), the property base will be very greatly reduced. Likewise, it will be necessary to determine the "invested capital" of the new company. If this is determined by taking half the new debt and the market value of the new stock, it will be approximately $89,000,000, and the "invested capital credit" will be $6,332,000, instead of $16,648,361—a reduction of $10,300,000. This difference in the invested capital credit means that $10,300,000 more of the earnings will be subject to the excess-profits tax. At the proposed rate of 90 percent, the additional excess-profits taxes on $10,000,000 would be $9,000,000.

If the plan had been in effect during 1942 with the basis of property adjusted as indicated, the 1942 taxes on the $24,140,000 which we expect to have available for charges as a result of 1942 earnings would be $15,540,279. Attached as exhibit 2 is a statement showing how this amount is computed. Bearing in mind that the Commission has estimated the normal earning power of the Rock Island to be $11,000,000 a year and has based its new capitalization upon that estimate, let us see what would happen to the new securities provided in the plan, unless relief is obtained in the way of the legislation which we are seeking.

In the hearings on the plan in the United States District Court at Chicago certain representatives of the General Mortgage bonds, the underlying security, introduced as exhibit 11 a statement showing how the securities would be affected by Federal income and excess-profits taxes at the rates imposed in the 1941 Revenue Act. Briefly, that exhibit showed that when the earnings in any year amounted to $11,600,000 ($600,000 in excess of what the Commission found normal), the company would be able to pay only the interest charges on the new bonds and would not even be able to provide the necessary sinking funds for retirement; the new stock would receive no dividends. Stated another way, 38½ percent of the new securities given to the creditors under the plan would have an income; 61½ percent would have none. The new stocks, on the theory on which this plan is constructed, would be worthless from the start, unless the earnings greatly exceeded the Commission's estimate of normal earning power; that is, the new stock has no prospect of a dividend unless the earnings are abnormally high.

Exhibit 11 showed that it would require net earnings of $26,659,308 (nearly two and one-half times what the Commission prognosticated) to pay the required 5-percent dividend on the new preferred stock; and until the earnings exceeded that figure, the new common stock, 41.2 percent of the total securities, would receive no return. Since the stockholders are eliminated in the reorganization, these new preferred and common stocks represent securities issued to creditors in exchange for their bonds.

But these damning figures were the result of the 1941 tax rates. When the 1942 rates are applied to the new capital structure, the results are fantastic. I have taken exhibit 11, and through the courtesy of the accounting department of the trustees in bankruptcy, have had the figures compiled to show the effect of the proposed 1942 rates. This statement is attached as exhibit 3; and in order to forestall skepticism as to the figures, exhibit 3 contains detailed computations of the taxes at each level of income mentioned. This statement shows that, with the proposed capital structure and the tax rates embodied in this bill, it would require earnings of $26,682,490 for the reorganized company to pay interest on its new bonds and to provide the capital and sinking funds required by the plan of reorganization. The capital stock, representing 61½ percent of the new capitalization, could not share in the earnings until they had exceeded $26,682,490, which is about two and one-half times what the Commission considered the normal earning power of the system.

The same statement shows that it would require net earnings of $64,182,490 to pay the full 5-percent dividend upon the preferred stock; so that the common stock, 41.2 percent of the total, could not receive a dollar until the earnings had exceeded $64,000,000, nearly six times what the Commission found to be normal.

The most fantastic figure of all, however, is found in column (f) of the statement, which shows that under these same tax rates it would require net earnings of $139,803,490 to provide a 5-percent dividend on the new common stock.

The effect of this on the plan and the disposition of security holders with regard to its acceptance is obvious. It already has manifested itself in the fight made on the Missouri Pacific plan, which is further along than the Rock Island. The Missouri Pacific plan has been rejected by the vote of 6 out of 16 classes of the security holders, for the simple reason that under the capital structure proposed, the revenues of the reorganized company are diverted to taxes. If security holders reject by their votes the pending plans of reorganization, the situation of the bankrupt roads is almost hopeless.

Other companies not reorganized will not be affected. Their tax bases are unimpaired; their invested capital and invested capital credit remain just as they are.

It is for this reason that we suggest that the basis of property, the invested capital, and the invested capital credit should not be affected by reorganization. The amendments we propose, which are attached as exhibit 5 to this statement, will accomplish that purpose.

If these amendments should be adopted, our taxes on this year's earnings would be $7,001,000. Attached as exhibit 4 is a statement showing the computations on which this figure is based.

This would leave $17,000,000 available for the security holders from this year's earnings, which would be sufficient to pay full dividends on the preferred stock and about $4 a share on the common. It is, of course, regrettable that it will take earnings of more than twice what the Commission called "normal earnings"

before dividends can be paid on the stock issued under the Commission's plan; but that distressing circumstance, when this inequity in the tax laws is removed, is a defect in the plan, and will, of course, be argued in the proper place. All that we can ask you to do here is to remove the discrimination between the companies which have been reorganized and those which have not been reorganized.

The justice of our position with respect to cancelation of indebtedness is exemplified by a reference to the Railroad Adjustment Act (chap. XV, Bankruptcy Act) into which the Congress incorporated a provision substantially similar to one of those for which we ask. This reads as follows:

"No income, gain, or profit taxable under any law of the United States or of any State, now in force or hereafter enacted, shall in respect to the adjustment of the indebtedness of any petitioner in a proceeding under this chapter be deemed to have accrued to or to have been realized by such petitioner by reason of a modification of or cancelation in whole or in part of any of the indebtedness of the petitioner affected by a proceeding under this chapter." (Bankruptcy Act, ch. XV, sec. 735.)

Somewhat similar provisions are embodied in supplement R of the Internal Revenue Code, which exempts gain or loss with respect to exchanges and distributions of securities under the Public Utility Holding Company Act of 1935, where made in obedience to the orders of the Securities and Exchange Commission.

These statutes do not relate to the tax base, because in neither case is the tax base affected by the procedure involved. Congress has alleviated the situation with respect to the basis of property of industrial corporations being reorganized under chapter X (formerly sec. 77B) by providing in section 270 that the Commissioner shall not reduce the new property base below the fair market value of the property. This is not a precedent for a railroad corporation, and the principle on which it is based is not applicable to a railroad corporation's property; because that property has no fair market value. It is not for sale; there is no possible purchaser. Moreover, it must be kept in operation, and in physical condition to render adequate and efficient service to the public.

In our judgment, the reason for treating the railroads in a different manner from industrial corporations with respect to their property base and invested capital, lies in this fundamental distinction between railroad property and railroad enterprise, one the one hand, and private property and private enterprise, on the other.

It is elementary in the law that a railroad company which devotes its property to the public service is entering into a very solemn undertaking. It enters into a compact with the public that it will furnish adequate service, at reasonable rates, without discrimination. Part of the compact is that it will submit to Government regulation of its rates and earnings, its operations and its investments, and its abandonments. What does it receive in return? Just one thing—the assurance that, so far as the public is concerned, it will be allowed to earn a reasonable return on the value of the property which it devotes to public use.

An important part of the carrier's obligation is to keep its property in readiness to handle all traffic that may be offered. It must always be ready to handle a peak load, no matter how long the preceding slump. The efficient performance of the national transportation system in the present emergency shows how well the carriers, including those in reorganization, have appreciated that obligation and prepared for it. But there is a corollary. Under our method of conducting the transportation business this obligation requires a constant inflow of new capital for every company. Not only must the railroad be maintained in condition to render adequate and efficient transportation service, but it must, by the very nature of the industry, be constantly providing a larger and a better structure. This is recognized by the Interstate Commerce Commission in its system of accounts, which requires that when an old facility is replaced with a new one, the excess cost and there usually is an excess cost) must be charged to capital account. It is recognized in the provisions of the pending reorganization plans, establishing a capital fund chargeable against earnings, usually immediately after the payment of fixed interest, requiring the company to set aside a specific amount for capital investments. In the Rock Island plan, this amount is fixed at 2 percent of the gross revenue, with a maximum of $3,000,000 a year. Before the junior securities, or the new stockholders, can receive any income, this provision must be made for adding to the invested capital of the enterprise.

This necessity continues regardless of the ownership of the property or the vicissitudes of its capital structure. Whether it goes through one reorganization or five, depending on the cycles of progress and poverty, the road must be kept

in operation; the actual amount of dollars invested in it must grow from year to year. As a going enterprise its "invested capital," as shown by its books, must continue to increase.

It follows that, until the property has earned a fair return upon that investment, there are no "excess profits" in any logical sense of the word. It is a violation of the public's covenant with the railway company and the people who have invested their money in its securities to take any action, whether through a State Legislature or commission or through the Interstate Commerce Commission or the Congress, that will shut off the right of the investors in such a transportation property to the fair return which the law allows. This is not saying that railroad corporations like all other properties should not pay the regular and normal rates of income tax applicable to all persons, whether corporate or individual. It is saying that, until the company has earned a fair return on its investment, the reduction of the invested capital base is as much a confiscation of property as a reduction of rates to a level which would preclude a fair return. It is denying that the Government may say to Road A, "Your 'invested capital' must be reduced because you have had a few bad years either from drought, flood, storm, or a general business depression;" while at the same time it says to Road B, which has survived the storm, "You may retain your 'invested capital credit,' and your taxes will be computed on your old base." This is the fundamental reason why the bankrupt railroads should not have their property bases reduced.

From a practical standpoint, the adoption of the suggested amendments will be advantageous to the Treasury, because it will facilitate reorganizations, and, therefore, expedite the flow of normal and surtaxes from these bankrupt roads into the Treasury. As matters stand now, reorganization proceedings are halted. The strenuous objections urged by junior bondholders against the Missouri Pacific plan were based on an increase of $7,000,000 in normal and surtaxes alone which would attach to the new company under the plan, to say nothing of excess-profits taxes. This same threat of increased taxes will delay and perhaps prevent the consummation of other similar plans, imposing an enormous hardship on all junior securities and stockholders.

The following figures illustrate how the Treasury is losing money through this failure to complete the pending reorganizations. They include nine class I railroads and their subsidiaries for which the Interstate Commerce Commission has approved reorganization plans that have so far failed to be completed. These roads operate some 50,000 miles of line, and have an aggregate investment in road and equipment of some $3,600,000,000:

	Mileage	Fixed charges and contingent interest charges for the year 1941—		
		On basis of present capitalization	On basis of capitalization in Interstate Commerce Commission plans	Decrease
New York, New Haven & Hartford	1,867	$14,176,000	$10,396,000	$3,780,000
Chicago, Milwaukee, St. Paul & Pacific	10,890	23,494,000	9,038,000	14,456,000
Chicago, Rock Island & Pacific	7,894	14,047,000	5,694,000	8,353,000
Chicago & North Western	8,327	16,396,000	9,013,000	7,383,000
Missouri Pacific	10,256	26,447,000	12,591,000	13,856,000
St. Louis-San Francisco	4,820	12,574,000	4,789,000	7,785,000
Western Pacific	1,208	3,035,000	1,449,000	2,186,000
St. Louis Southwestern	1,090	3,109,000	1,514,000	1,595,000
Denver & Rio Grande Western	2,784	6,953,000	5,019,000	1,934,000
Total	49,736	120,831,000	59,533,000	61,298,000

This statement shows the fixed and contingent interest charges for the year 1941 on the nine roads referred to, and indicates a total decrease in fixed and contingent interest charges on these roads if the reorganization plans should be completed of $61,298,000. At the 1941 rates the normal and surtaxes on this amount would be $19,000,000, which the Government has not received. At the normal and surtax rates proposed by the Treasury in the present bill, the total tax which the Government is not collecting and could collect, if the reorganizations were completed, is probably in excess of $35,000,000.

We mention this practical aspect of the matter only in passing. We advocate the changes we have proposed, because we think that, from an accounting, legal, and practical standpoint, they are right.

Moreover, from the standpoint of public policy and the development of a sound and efficient transportation system, these changes are essential. The very safety of the country at this moment depends upon adequate rail transportation. The railroads are giving it because they are prepared. The Rock Island is giving it because it is in excellent physical shape, and because the trustees during their administration have wisely, under the orders of the court, invested over $50,000,000 of new capital in physical improvements. I do not mean in maintenance; not only have the trustees maintained the property, but they have spent over $50,000,000 in cash in improving it. They got the money by taking their earnings and investing them in rails, ties, cars, and locomotives instead of paying them to the creditors, who have received no substantial sums since we filed a reorganization petition in 1933; and who are now required to take in discharge of their claims these mere tokens of a misplaced faith.

But if this reorganization is completed and the tax law is not amended, who will then provide the new capital which we must have, and what will be the effect if the emergency continues for 4 or 5 years after reorganization? Certainly not the new company because, as shown by the statements I have handed you, most of the earnings will have gone for taxes. Certainly not the security holders of the new company, because even on these earnings, war time earnings, they are receiving no return on the larger portion of their new securities. Certainly not the investing public; because this treatment of present securities under these plans is a warning against future investments.

The necessity for new capital is paramount; it is inevitable. If it can be obtained only by foregoing again the payment of interest charges, then the credit of the new company is destroyed, and one important part of the country's transportation system is back in the Court's hands, its credit forever gone.

EXHIBIT 1

Income tax computation, Basis of Old Capitalization and Estimated Income Year 1942 Computed at Rates Passed by House of Representatives July 20, 1942

Excess profits tax:		
Invested capital:		
½ of debt		$160,874,706
Capital stock on basis of $100 par value		128,892,512
Total		289,767,218
Invested capital credit:		
Specific	$10,000	
8 percent on first $5,000,000	400,000	
7 percent on second $5,000,000	350,000	
6 percent on next $190,000,000	11,400,000	
5 percent all over $200,000,000	4,488,361	
Total invested capital credit		16,648,361
Earnings available for interest charges [1]		24,140,730
Less:		
½ of fixed interest	$6,778,316	
Service loss on property retired and not replaced	2,792,632	
		9,570,948
Excess profit net income [2]		14,569,782
Less invested capital credit		16,648,361
Adjusted excess-profits net income		None
Excess-profits tax, 90 percent		None
Normal and surtax:		
Excess-profits net income [2]		14,569,782
½ of fixed interest		6,778,316
Normal and surtax net income		7,791,466
Normal tax, 24 percent		1,869,952
Surtax tax, 21 percent		1,636,208
Total Federal income taxes		3,506,160

[1] Based on 6 months' actual earnings and 6 months' estimated earnings.
[2] No deduction made for operating carry-over losses, years 1940–41.

EXHIBIT 2

Federal income and excess-profits tax computation basis of new capitalization pursuant to Interstate Commerce Commission reorganization plan and estimated income, year 1942, computed at rates passed by House of Representatives July 20, 1942

Excess-profits tax:	
Invested capital:	
½ of debt (par value)	$70,942,488
Preferred stock at $15 a share	11,250,000
Common stock at $5 a share	7,562,120
Total invested capital	89,754,608
Invested capital credit:	
Specific	10,000
8 percent on first $5,000,000	400,000
7 percent on next $5,000,000	350,000
6 percent on all over $10,000,000	4,785,276
Total invested capital credit	5,545,276
Earnings available for charges[1]	24,140,730
Plus: Service loss on property retired and replaced (1941)	681,315
Net earnings available for charges[1]	24,822,045
Deductions:	
½ of fixed and contingent interest	2,895,086
Retirements:	
Service loss on property retired and replaced $681,315, shrunk 87.34 percent	86,254
Service loss on property retired and not replaced $2,702,632, shrunk 87.34 percent	353,547
Total deductions	3,334,887
Excess-profits net income	21,487,158
Less invested capital credit	5,545,276
Adjusted excess-profits net income	15,941,882
Excess-profits tax 90 percent	14,347,694
Normal and surtax:	
Excess-profits net income	21,487,158
½ of fixed and contingent interest	2,895,086
Adjusted excess-profits net income	15,941,882
Normal and surtax net income	2,650,190
Normal tax 24 percent	636,045
Surtax 21 percent	556,540
Total normal and surtax	1,192,585
Total Federal income and excess-profits tax	15,540,279

[1] Based on 6 months' actual earnings and 6 months' estimated earnings.

EXHIBIT 3

THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY CO., FRANK O. LOWDEN, JOSEPH B. FLEMING, TRUSTEE

Statement showing amount of income available for fixed charges before deducting Federal income taxes, required to be earned in order to pay such taxes, fixed charges, contingent charges, 5 percent on the preferred stock and 5 percent on common stock of the reorganized company if reorganization is consummated in accordance with Interstate Commerce Commission modified plan approved Aug. 12, 1941, also similar figures based on 1942 income (6 months actual and 6 months estimate) computed at rates passed by House of Representatives July 20, 1942

Items	Amounts necessary to pay Federal income taxes and—						Column (g) year 1942 6 months actual and 6 months estimated income
(a)	Fixed charges (b)	Column (b) plus capital and sinking fund (c)	Column (c) plus interest on general "A" 4½'s (d)	Column (d) plus sinking fund 4½'s (e)	Column (e) plus preferred dividend at $5 (f)	Column (f) plus common dividend at $5 (g)	(h)
1. "Income available for fixed charges" before deducting Federal taxes required (see note)	$2,152,672	$10,860,502	$22,682.040	$26,682,490	$64,182,490	$139,803,490	$24,735,791
2. Deduct Federal tax:							
a. Normal and surtax	None	2,011,023	1,192,586	1,192,586	1,192,586	1,192,586	1,192,585
b. Excess-profits tax	None	3,496,807	12,499,282	16,099,732	49,849,732	117,908,632	14,347,694
Total Federal income taxes	None	5,507,830	13,691,868	17.292,318	51,042,318	119,101,218	15,540,279
3. Balance available for fixed charges	2,152.672	5,352,672	8,990,172	9.390,172	13.140,172	20,702,272	9,195,512
4. Deduct fixed charges	2,152,672	2,152.672	2,152,672	2,152.672	2.152,672	2,152,672	2,152,672
5. Available net	None	3,200,000	6,837,500	7,237,500	10,987,500	18,549,600	7,042,840
Applicable of item 5:							
6. Capital fund and first mortgage sinking fund	None	3,200,000	3,200,000	3,200,000	3,200,000	3,200,000	3,200,000
7. Reimbursement of Treasury for fixed charges paid in excess of earnings	None	None	None	None	None	None	None
8. Sinking fund for bonds sold to purchase equipment	None	None	None	None	None	None	None
Contingent interest:							
9. Interest on general mortgage, 4½'s "A"	None	None	3,600,000	3,600,000	3,600,000	3,600,000	3,600,000
10. Sinking fund on general mortgage, 4½'s	None	None	None	400.000	400,000	400,000	205,340
11. Reconstruction Finance Corporation contingent interest, 1½ percent	None	None	37,500	37,500	37,500	37,500	37,500
12. Preferred dividend at $5	None	None	None	None	3,750,000	3,750.000	----------
13. Common dividend at $5	None	None	None	None	None	7,562,100	----------

NOTE.—Amounts of income in item 1 determined by adding to the sum of items 4 to 13 the amounts of Federal income taxes, if any (item 2) which taxes are computed on taxable income after appropriate adjustments for retirement chargess so as to leave available the amounts required to service items 6, 9, 10, 11, 12, and 13 where shown.

INCOME TAX COMPUTATION, COLUMN "C"

(1) Excess-profits tax:		
Invested capital:		
One-half of debt (par value)		$70,942,488
Preferred stock, at $15 a share		11,250,000
Common stock, at $5 a share		7,562,120
Total invested capital		89,754,608
Invested capital credit:		
Specific	$10,000	
8 percent on first $5,000,000	400,000	
7 percent on second $5,000,000	350,000	
6 percent on all over $10,000,000	4,785,276	
		5,545,276
Earnings available for charges		10,860,500
One-half of fixed interest	$1,076,336	
Retirements of $2,792,632 shrunk 87.34 percent	353,547	
		1,429,883
Excess-profits net income		9,430,617
Less, invested capital credit		5,545,276
Adjusted excess profits net income		3,885,341
Excess-profits tax 90 percent		3,496,807
(2) Normal and surtax:		
Excess-profits net income		9,430,617
One-half of fixed interest	$1,076,336	
Adjusted excess-profits net income	3,885,341	
		4,961,677
Normal and surtax net income		4,468,940
Normal tax, 24 percent	$1,072,546	
Surtax, 21 percent	938,477	
Total normal and surtax		2,011,023
Total Federal income and excess-profits tax		5,507,830

INCOME TAX COMPUTATION, COLUMN "D"

(1) Excess-profits tax:		
Invested capital:		
½ of debt (par value)		$70,942,488
Preferred stock at $15 a share		11,250,000
Common stock at $5 a share		7,562,120
Total invested capital		89,754,608
Invested capital credit:		
Specific	$10,000	
8 percent on first $5,000,000	400,000	
7 percent on second $5,000,000	350,000	
6 percent on all over $10,000,000	4,785,276	
		5,545,276
Earnings available for charges		22,682,000
½ of fixed and contingent interest	$2,895,086	
Retirements of $2,792,632 shrunk 87.34 percent	353,547	
		3,248,633
Excess-profits net income		19,433,367
Less invested capital credit		5,545,276
Adjusted excess profits net income		13,888,091
Excess-profits tax, 90 percent		12,499,282

(2) Normal and surtax:		
Excess-profits net income		$19, 433, 367
½ of fixed interest	$2, 895, 086	
Adjusted excess-profits net income	13, 888, 091	
		16, 783, 177
Normal and surtax net income		2, 650, 190
Normal tax, 24 percent	$636, 046	
Surtax, 21 percent	556, 540	
Total normal and surtax		1, 192, 586
Total Federal income and excess-profits tax		13, 691, 868

INCOME TAX COMPUTATION, COLUMN "E"

(1) Excess profits tax:		
Invested capital:		
½ of debt (par value)		$70, 942, 488
Preferred stock, at $15 a share		11, 250, 000
Common stock, at $5 a share		7, 562, 120
Total invested capital		89, 754, 608
Invested-capital credit:		
Specific	$10, 000	
8 percent on first $5,000,000	400, 000	
7 percent on second $5,000,000	350, 000	
6 percent on all over $10,000,000	4, 785, 276	
		5, 545, 276
Earnings available for charges		26, 682, 500
½ of fixed and contingent interest	$2, 895, 086	
Retirements of $2,792,632 shrunk 87.34 percent	353, 547	
		3, 248, 633
Excess profits net income		23, 433, 867
Less invested-capital credit		5, 545, 276
Adjusted excess-profits net income		17, 888, 591
Excess-profits tax 90 percent		16, 099, 732
(2) Normal and surtax:		
Excess-profits net income		23, 433, 867
½ of fixed interest	$2, 895, 086	
Adjusted excess-profits net income	17, 888, 591	
		20, 783, 677
Normal and surtax net income		2, 650, 190
Normal tax 24 percent	$636, 046	
Surtax 21 percent	556, 540	
Total normal and surtax		1, 192, 586
Total Federal income and excess-profits tax		17, 292, 318

INCOME TAX COMPUTATION, COLUMN "F"

(1) Excess-profits tax:		
Invested capital:		
½ of debt (par value)		$70, 942, 488
Preferred stock, at $15 a share		11, 250, 000
Common stock, at $5 a share		7, 562, 120
Total invested capital		89, 754, 608

(1) Excess-profits tax—Continued.		
Invested-capital credit:		
Specific	$10,000	
8 percent on first $5,000,000	400,000	
7 percent on second $5,000,000	350,000	
6 percent on all over $10,000,000	4,785,276	
		$5,545,276
Earnings available for charges		64,182,500
½ of fixed and contingent interest	$2,895,086	
Retirements of $2,792,632 shrunk 87.34 percent	353,547	
		3,248,633
Excess-profits net income		60,933,867
Less invested-capital credit		5,545,276
Adjusted excess-profits net income		55,388,591
Excess-profits tax, 90 percent		49,849,732
(2) Normal and surtax:		
Excess-profits net income		60,933,867
One-half of fixed interest	$2,895,086	
Adjusted excess-profits net income	55,388,591	
		58,283,677
Normal and surtax net income		2,650,190
Normal tax, 24 percent	$636,046	
Surtax tax, 21 percent	556,540	
Total normal and surtax		1,192,586
Total federal income and excess-profits tax		51,042,318

INCOME-TAX COMPUTATION, COLUMN "G"

(1) Excess profits tax:		
Invested capital:		
½ of debt (par value)		$70,942,488
Preferred stock, at $15 a share		11,250,000
Common stock, at $5 a share		7,562,120
Total invested capital		89,754,608
Invested-capital credit:		
Specific	$10,000	
8 percent on first $5,000,000	400,000	
7 percent on second $5,000,000	350,000	
6 percent on all over $10,000,000	4,785,276	
		5,545,276
Earnings available for charges		139,803,500
½ of fixed and contingent interest	$2,895,086	
Retirements of $2,792,632 shrunk 87.34 percent	353,547	
		3,248,633
Excess-profits net income		136,554,867
Less invested-capital credit		5,545,276
Adjusted excess-profits net income		131,009,591
Excess-profits tax, 90 percent		117,908,632

(2) Normal and surtax:		
Excess-profits tax income		$136,554,867
½ of fixed interest	$2,895,086	
Adjusted excess-profits net income	131,009,591	
		133,904,677
Normal and surtax net income		2,650,190
Normal tax, 24 percent	$636,046	
Surtax, 21 percent	556,540	
Total normal and surtax		1,192,586
Total Federal income and excess-profits tax		119,101,218

INCOME TAX COMPUTATION, COLUMN "H"

(1) Excess-profits tax:		
Invested capital:		
½ of debt (par value)		$70,942,488
Preferred stock at $15 a share		11,250,000
Common stock at $5 a share		7,562,120
Total invested capital		89,754,608
Invested capital credit:		
Specific		10,000
8 percent on first $5,000,000		400,000
7 percent on next $5,000,000		350,000
6 percent on all over $10,000,000		4,785,276
Total invested-capital credit		5,545,276
Earnings available for charges [1]		24,140,736
Plus: Service loss on property retired and replaced (1941)		681,315
Net earnings available for charges [1]		24,822,045
Deductions:		
½ of fixed and contingent interest		2,895,086
Retirements:		
Service loss on property retired and replaced, $681,315 shrunk 87.34 percent		86,254
Service loss on property retired and not replaced, $2,792,632 shrunk 87.34 percent		353,547
Total deductions		3,334,887
Excess profits net income		21,487,158
Less invested-capital credit		5,545,276
Adjusted excess-profits net income		15,941,882
Excess-profits tax 90 percent		14,347,694
(2) Normal and surtax:		
Excess-profits net income		21,487,158
½ of fixed and contingent interest		2,895,086
Adjusted excess-profits net income		15,941,882
Normal and surtax net income		2,650,190
Normal tax, 24 percent		636,045
Surtax, 21 percent		556,540
Total normal and surtax		1,192,585
Total Federal income and excess-profits tax		15,540,279

[1] Based on 6 months actual earnings and 6 months estimated earnings.

EXHIBIT 4

Federal income and excess-profits-tax computation basis of Interstate Commerce Commission reorganization plan and the adoption by the Treasury Department of the proposed amendments to the statutes, using estimated income, year 1942, computed at rates passed by House of Representatives July 20, 1942

Excess-profits tax:	
Invested capital:	
½ of debt (par value)	$70,942,488.00
Equity invested capital	362,924,204.00
Total invested capital	433,866,692.00
Invested capital credit:	
Specific	10,000.00
8 percent on first $5,000,000	400,000.00
7 percent on next $5,000,000	350,000.00
6 percent on next $190,000,000	11,400,000.00
5 percent on $233,866,692	11,693,335.00
Total invested-capital credit	23,853,335.00
Earnings available for charges[1]	24,140,730.00
Deductions:	
½ of fixed and contingent interest	2,895,066.00
Retirements, Service loss on property retired and not replaced	2,792,632.00
Total deductions	5,687,698.00
Excess-profits net income	18,453,032.00
Less invested-capital credit	23,853,335.00
Adjusted excess-profits net income	None
Excess-profits tax, 90 percent	None
Normal and surtax:	
Excess-profits net income	18,453,032.00
½ of fixed and contingent interest	2,895,066.00
Adjusted excess-profits net income	None
Normal and surtax net income	15,557,966.00
Normal tax, 24 percent	3,733,912.00
Surtax, 21 percent	3,267,172.00
Total normal and surtax	7,001,084.00
Total Federal income and excess-profits tax	7,001,084.00

COMPUTATION OF INVESTED CAPITAL CREDIT BASED ON PRO FORMA BALANCE SHEET DEC. 31, 1941

Book value of assets, undepreciated		$445,492,741.04
Add credit balance in acquisition adjustment account		136,681,769.91
Unadjusted basis of assets		582,174,510.95
Less accrued depreciation, equipment		64,112,165.35
Adjusted basis of assets		518,062,345.60
Deduct liabilities:		
Long-term debt	$141,884,976.00	
Current liabilities	13,615,302.57	
Deferred liabilities	469,419.82	
Other unadjusted credits	2,138,443.40	
		155,108,141.69
Equity invested capital at Dec. 31, 1941		362,924,203.91
Add ½ of borrowed capital		70,942,488.00
Total invested capital		433,866,691.91

[1] Based on 6 months' actual earnings and 6 months' estimated earnings.

Invested capital credit:	
Specific exemption	$10,000.00
8 percent on first $5,000,000	400,000.00
7 percent on second $5,000,000	350,000.00
6 percent on next $190,000,000	11,400,000.00
5 percent on $233,866,691.91	11,693,334.59
	23,853,334.59

EXHIBIT 5

PROPOSED AMENDMENTS

Section 113 of the Internal Revenue Code should be amended, applicable to all taxable years beginning after December 31, 1938, by adding at the end thereof the following new subsection:

"(c) REORGANIZATION OF COMMON CARRIER BY RAILROAD.—Notwithstanding the provisions of subsections (a) and (b) of this section and the provisions of section 114, the basis of property of a common carrier by railroad shall not be increased or decreased as a result of any judicial reorganization; and where in any such reorganization, one or more new corporations are organized and pursuant to such plan of reorganization acquire property of such common carrier, the basis of such property to the new corporation or corporations, shall be the same as the basis of such property would have been to the old corporation had there been no such judicial reorganization."

Section 112 of the Internal Revenue Code should be amended, applicable to all taxable years beginning after December 31, 1938, by adding at the end thereof the following new subsection:

"(l) REORGANIZATION OF COMMON CARRIER BY RAILROAD.—No income, gain, or profit shall, in respect to the adjustment of the indebtedness of any railroad corporation in any judicial reorganization, be deemed, under any law of the United States or of any State now in force or hereafter enacted, to have accrued or to have been realized by such corporation, or any successor or successors in such reorganization by reason of the modification or cancelation in whole or in part of the principal or interest of any such indebtedness of such corporation."

STATEMENT BY A. N. WHITLOCK, COUNSEL FOR TRUSTEES, CHICAGO, MILWAUKEE, ST. PAUL & PACIFIC RAILROAD CO., CHICAGO, ILL.

STATEMENT RE NECESSITY FOR AMENDMENT TO REVENUE LAWS AFFECTING REORGANIZED RAILROADS

At the outset I desire to state that those of us who appear in behalf of the railroads in reorganization fully appreciate the necessity of increasing revenue to the Government to meet the demands of war and we realize that the time is not opportune for any proposals designed to reduce taxes. Consistent with that understanding, we do not propose or advocate any plan under which the income tax of such railroads after reorganization would be reduced as a result of the reorganization. In fact, apart from the increase in rates, the income-tax bill of such railroads will, as a result of reorganization be substantially increased as will be hereafter demonstrated. Our purpose, on the contrary, is to correct a method or rule which in its application would penalize the reorganized railroad and require it, by reason of its previous financial distress and inability to meet its obligations, to pay more tax than it would have been required to pay upon the same income if it had been able to avoid reorganization.

STATEMENT OF THE PROBLEM

The situation which presents our difficulties arises in this way. In arriving at the taxable income of any railroad, for the purpose of computing the normal income tax, the items of depreciation and retirements are deductible expenses and in the railroad industry these items are quite substantial.

Depreciation is computed by applying percentages, approved by the Interstate Commerce Commission, to the cost of the property on which depreciation is to be accrued. The theory applying to depreciation is that the expense of operation includes the cost of property consumed in earning income and that, by setting aside amounts equal to the depreciation charges throughout the useful life of

the property, the total amount of depreciation will provide for the replacement of the property at the end of its life. Depreciation accounting is applied generally to equipment but, as to fixed property, most railroads, instead of depreciation, apply retirement accounting under which the cost of the unit of property retired, less the value of salvage recovered, if any, is deducted at the time of retirement. Both depreciation and retirements are allowable deductions for income-tax purposes, the difference being that depreciation is deducted annually, whereas the retirement loss is deducted all at one time. After January 1, 1943, it is expected that the Interstate Commerce Commission will require that the depreciation method be followed as to all depreciable property except certain excepted track property.

Also, in computing the excess-profits tax, the credit provided by the law is an important item, and that credit for railroads undergoing reorganization must obviously be based upon the invested capital method. In general, invested capital is the sum of the average equity invested capital and 50 percent of the average borrowed capital less the inadmissible assets. In arriving at the equity invested capital, section 718 (a) (2) provides that property paid in for stock shall be included in an amount equal to its basis (unadjusted) as provided by section 113 (a), with certain specified limitations and reduced as provided in section 718 (b).

It is apparent, then, that, in arriving at the deductions to be taken by the taxpayer for depreciation and retirements and in arriving at the excess-profits credit, the cost of the property to the taxpayer is the basic figure which is used and is commonly referred to as the tax base. Any reduction of the tax base results, in turn, in a reduction in the items of depreciation and retirements or the excess-profits credit, as the case may be.

Many of the railroads of the country are in the process of reorganization under section 77 of the National Bankruptcy Act. Under that section plans of reorganization must be approved by the Interstate Commerce Commission and the Court. The Commission has approved plans for the reorganization of railroads in more than 20[1] cases and many others have not reached the stage of an approved plan. In the plans so far promulgated by the Interstate Commerce Commission there has been uniformly a substantial reduction in the capitalization of the company. In a majority of the instances the stock of the existing company has been found to be of no value. The indebtedness has been substantially reduced and the old bondholders given new securities at least in part of inferior grade, in many instances the junior bondholders receiving only stock in the reorganized corporation.

As an illustration, and using round figures only, in a recent plan proposed for one of the larger railroads the original cost of the property of the old company was in excess of $700,000,000 whereas the total capitalization authorized in the plan, taking the no-par stock at a valuation of $100 per share, was fixed at somewhat in excess of $500,000,000, of which approximately $200,000,000 represented total system debt.

In a case of this character the Interstate Commerce Commission has approved accounting regulations conforming to its decision in the *Chicago Great Western Case, Ex parte 138* (247 I. C. C. 193), which require a reorganized carrier to set up in its property accounts the original cost or estimated original cost as found by the Bureau of Valuation of the Interstate Commerce Commission as the "basis of the property" to be used for determining depreciation charges and retirement losses. For tax purposes, however, the Bureau of Internal Revenue, for the purpose of computing depreciation, applies section 114 of the Internal Revenue Code which prescribes the adjusted basis set forth in section 113 (b). This basis is interpreted by the Bureau to mean the cost to the new company, to be arrived at by taking the par value of the new bonds of the reorganized company plus the market value of the stock. The date for computing such market value has not been definitely determined but presumably it is either the date of final confirmation of the plan or the date of consummation thereof. Whichever date is taken, experience shows that the price of the new stock in such early state of a reorganization is not likely to be quoted at a figure in excess of $10 per share and usually much less than that. The result is that, in arriving at the tax base, only one-tenth of the value used in the plan of reorganization for the property represented by stock in the new corporation is recognized, and the depreciation, retirements and excess profits credit are correspondingly reduced.

[1] List of railroads as to which plans had been approved by the Commission as of October 31, 1941, is appended.

TAX-FREE REORGANIZATION

The basis prescribed by section 113, unadjusted, as pointed out above, is the cost of the property, but subdivision (a) provides, among other things, that in cases where the property is acquired in a taxable year beginning after December 13, 1925, by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor. Reorganization, as here used, means a so-called tax-free reorganization, and such reorganization is specifically defined by section 112 (g) (1) which lists six different types of reorganization. The law, as to the proper interpretation of this section, has been and still is quite unsettled. The latest developments are represented by a number of decisions of the Supreme Court of the United States. In the light of one of these decisions, *Helvering* v. *Southwest Consolidated Corporation* (U. S. Sup. Ct. 86 L. Ed., Advance Edition, 512), the possibility of the ordinary railroad reorganization coming within the definition set forth in section 112 (g) (1) is extremely doubtful and that doubt is not removed by the refusal of the Court to take jurisdiction in a certiorari proceeding in the case of *Helvering* v. *N. H. & S. L. R.* (121 Fed. (2d) 895), in which case the Supreme Court denied certiorari on February 9, 1942.

Reorganizations which fail so to qualify take the base prescribed by section 113, that is, cost, which, under the proposal of the Bureau, will be construed to mean cost to the new company arrived at in the manner indicated earlier.

DISCRIMINATION AGAINST ROADS IN REORGANIZATION

Illustrations of the severe penalties resulting to the reorganized roads by the proposed application of the tax law are set forth in considerable detail in the printed memorandum entitled "Federal Tax Problem of Railroads in Reorganization" prepared by the Association of American Railroads and the Railroad Security Owners Association, Inc., and they need not be repeated at this point. In the case of the railroad used earlier for illustration, where the original cost of the property to the old company was in excess of $700,000,000 and the total capitalization authorized in the plan was fixed somewhat above $500,000,000, it has been estimated that the application of the rule proposed by the Bureau would reduce the tax base for that company from $700,000,000 to approximately $200,000,000, with a corresponding reduction in depreciation, retirements, and excess-profits credit. The result is graphically illustrated in the memorandum referred to by a comparison of two railroads having identical properties with the same original cost, the same debt and stock, and the same earnings for a given year. One of these railroads is not reorganized and the other is reorganized and operates upon the reorganized basis for the year in question. In the two cases compared, it is assumed that the plan of reorganization reduces the debt of the reorganized railroad from $300,000,000 to $125,000,000 and leaves the stock the same. In the comparison the market value of stock of the reorganized road is assumed to be $15 per share. The computation shows that the tax upon the reorganized railroad, upon the same earnings, is more than nine times the tax upon the road which is not reorganized.

Certainly the tax law should not be applied in such a fashion as to discriminate between railroads which have been reorganized and those which have been fortunate enough to escape reorganization. An engine or other piece of equipment of the same cost and quality depreciates to the same extent upon one road as upon another. The same may be said of a bridge or other structure. As pointed out above, the theory of depreciation is that by the end of the life of the structure the amount of depreciation will offset the original cost of the property. This theory should apply with uniformity to railroads regardless of their financial condition, yet under the rule proposed to be applied, the depreciation would be reduced in the same proportion as the tax base is reduced.

We do not believe that it was the intention of Congress, in enacting section 77, that the tax burden should be increased by reason of reorganization except insofar as increase might result from a reduction in the interest obligations of the company. Obviously, the purpose of the enactment of section 77 was to aid railroads in financial difficulties and to assist them in the solution of those difficulties, yet the existing provisions of the internal-revenue law, as presently applied to reorganized railroads, greatly increase the tax over that of solvent railroads similarly situated and over what it would be were there no reorganization. Such a result operates to defeat the real purposes of reorganization and jeopardizes the credit of the reorganized company. In fact, the proposed application of the law may result in making it practically impossible for some railroads to emerge from pending reorganization proceedings.

REDUCTION IN INTEREST CHARGES

It was pointed out earlier that reorganizations will result in a certain increase in tax to which there is no objection and which is based upon sound financial considerations. This may be illustrated in the following manner: One of the principal results of all reorganization plans is to reduce the debt of the corporation and correspondingly to reduce the interest charges. Interest accruals represent deductions which are taken in arriving at taxable income. If a railroad having outstanding indebtedness of $500,000,000 reorganized and its debt reduced to $250,000,000, then, if there were no change in the rate of interest as between the old and new debt, the interest payments would be cut in half and the other half, which had theretofore been deducted, would pass into taxable income and increase the tax accordingly. The solvent railroads and the railroads which are in the process of reorganization now deduct the interest accruals upon their existing indebtedness but when those which are in the process of reorganization come out under a new plan which reduces the debt, the resulting increase in tax to the Government will follow which would seem to make it desirable, from the point of view of the Government, that the completion of pending reorganizations be facilitated as much as possible. There is no objection to the increase in tax resulting from reduced interest charges. There is an offsetting advantage to the corporation in that the interest burden is reduced, but there would seem to be no sound reason why, in addition to this increase, a further and much more severe one should be imposed by means of a reduction in the tax base though the reorganized company continues with the very same property that the old corporation had. This result should be avoided by remedial legislation. Such legislation might take various forms to reach the same equitable objective.

REMEDIAL LEGISLATION

Perhaps, the simplest method would be to amend section 113 of the Revenue Code so as to provide that the basis of property of a common carrier by railroad shall not be increased or decreased as a result of a reorganization under section 77 or any judicial reorganization but that the basis of such property shall be the same as the basis would have been to the old corporation had there been no such reorganization. This is the type of amendment to existing law proposed by the memorandum referred to, prepared by the Association of American Railroads and the Railroad Security Owners Association, Inc. The same result might be accomplished by the amendment of section 112 (g) (1) of the Internal Revenue Code to so define reorganization as to include reorganizations of railroads under section 77. Perhaps, the most logical method would be to provide that in the case of reorganized railroads the basis of the property for depreciation, retirement, and excess-profits purposes shall be determined in accordance with the effective classifications of the Interstate Commerce Commission and, more particularly, in accordance with the Interstate Commerce Commission's decision of June 16, 1941, in the *Chicago Great Western Case, Ex parte No. 138* (247 I. C. C. 193). This method is referred to as the more logical for the reason that its adoption would produce uniformity in the treatment of the same subject as between the Interstate Commerce Commission and the Bureau of Internal Revenue, which would be a desirable result and would greatly simplify procedure.

FURTHER PROBLEM ARISING FROM CANCELATION OF INDEBTEDNESS

The foregoing has dealt entirely with the questions of depreciation, retirements, and excess-profits credit. A further penalty threatens reorganized railroads by reason of the fact that since the reorganization invariably reduces the debt, quite substantially, there is the probability that this reduction of cancelation of indebtedness incident to reorganization may be held to be income in the year in which the reorganization is consummated, or, if the same should be excluded from gross income under section 22 (b) (9), the whole or a part of the amount so excluded would be applied to reduce the basis of the property of the reorganized company under section 113 (b) (3) which would give rise in a lesser degree to the same discrimination and the same penalties heretofore pointed out. The law upon this question is likewise unsettled and the results so obviously unfair can only be avoided by further amendment to provide that in the case of reorganization of a common carrier by railroad no income, gain, or profit shall, in respect to the adjustment of indebtedness of the reorganized company, be deemed to have accrued.

It will be noted that the act of 1939, providing for railroad adjustments, which appears as chapter XV of the Bankruptcy Act, specifically provides, section 735, that no taxable income, gain, or profit shall be deemed to have accrued in respect to the modification of, or cancelation in whole or in part of, any of the indebtedness of the petitioner affected by the proceeding. In proceedings under this chapter, the basis of debtor's property is not reduced. This statute is limited in its application and does not apply to railroads in reorganization under section 77.

Reference should also be made to supplement R relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission (secs. 371, 372, and 373 of the Internal Revenue Code). These sections provide that, in the case of exchanges and distributions made in obedience to such orders, no gain or loss shall be recognized and in general the basis of the property in the hands of the transferor carries through. These cases arise out of transactions which are required by orders of the Securities and Exchange Commission. The reduction of debt and the readjustment of the capitalization of railroads which are required to seek relief under section 77 of the Bankruptcy Act are made necessary by the administration of that section by the Interstate Commerce Commission and the courts. The two situations would seem to be comparable and would likewise seem to justify treatment for tax purposes in a manner to conform to the spirit and purposes of the law under which the transactions arise.

EXCESS PROFITS

Viewed from the standpoint of excess profits, as I understand the theory, it is that income in excess of some normal figure should be heavily taxed as excess profits. It would seem fair to say that the point at which excess profits begin should not be reached until there is a fair return upon the prudent investment in the property. Certainly there should not be one rule applying to a reorganized railroad and another to a solvent railroad.

The practical application of existing revenue laws in the manner proposed to reorganized railroads results in a vicious circle. Such railroads are in effect told that their lack of earnings prior to reorganization has brought on financial disaster which, in turn, has reduced and unduly depressed their property values and upon the basis of such depressed values their earnings are excessive and must be taxed as excess profits.

Railroads are public service corporations. Their services and operations are completely regulated. Their rates are under the jurisdiction of the Interstate Commerce Commission and various State commissions. Their accounting, their financial transactions, and many other matters are likewise directly supervised and regulated by the Interstate Commerce Commission. Their labor relations are governed by Federal statute, and the rate of pay to their employees is arrived at through the operation of Government agencies. The most important considera tion in connection with their continued and efficient operation is the public interest. These considerations should be kept in mind in arriving at a proper conclusion as to the tax base, and a rule should be adopted which will uniformly affect and apply to the industry as a whole.

Railroads reorganized and otherwise, like all other persons and corporations, should bear their fair share of the tax burden. No one contends otherwise. But taxes are paid out of income which must first be earned and which can be earned only if the property dedicated to the business of earning is kept in good condition and a sound financial structure is maintained. Any rule which unduly reduces the basis of depreciation and thus makes replacement more difficult or which re duces the basis for determining fair return below the actual investment in the property, directly impairs the ability to earn. The objection is not to uniformly higher rates of tax for all but to the application of rules of computation which discriminate against a class already in financial difficulty.

RAILROADS IN WHICH PLANS OF REORGANIZATION HAVE BEEN APPROVED BY THE INTER-STATE COMMERCE COMMISSION AS OF OCTOBER 31, 1941

The Akron, Canton & Youngstown Railway Co.; Alabama, Tennessee & Northern Railroad; Boston & Providence Railroad; Chicago & Eastern Illinois Railroad; Chicago & North Western Railway Co.; Chicago Great Western Railway; Chicago, Milwaukee, St. Paul & Pacific Railroad Co.; The Chicago, Rock Island & Pacific Railway Co.; Chicago, South Shore & South Bend Railroad; Copper

Range Railroad Co.; Erie Railroad (including Chicago & Erie); Fort Dodge, Des Moines & Southern Railroad Co.; Kansas City Kaw Valley & Western Railroad; The Louisiana and North West Railroad Co.; Missouri Pacific Railroad Co.; The New York, New Haven & Hartford Railroad Co.; Oregon, Pacific & Eastern Railway; Reader Railroad; St. Louis-San Francisco Railway Co.; St. Louis Southwestern Railway Lines; Savannah & Atlanta Railway Co.; Spokane International Railroad; The Western Pacific Railroad Co.; Yosemite Valley Railway Co.

All right, Mr. Dorety.

STATEMENT OF F. G. DORETY, ST. PAUL, MINN., VICE PRESIDENT AND GENERAL COUNSEL OF THE GREAT NORTHERN RAILROAD

Mr. DORETY. My name is F. G. Dorety, St. Paul, Minn. I am vice president and general counsel of the Great Northern Railroad.

Speaking for that company and a few other important railroads, I am asking you to amend the excess-profits tax chapter by making it clear and certain that companies using the invested-capital basis and buying cars or locomotives under conditional-sales contracts can include that debt in their borrowed capital for computing excess profits.

Under the present act, section 719 (a) (1), borrowed capital is limited to debt that is evidenced by a bond, note, debenture, bill of exchange, certificate of indebtedness, mortgage, or trust deed.

A conditional-sales contract contains a specific promise to pay principal and interest on specified dates. It might be argued that it is a note within the present act, but, on the other hand, it has provisions [illegible]e and use of property. It is not ordinarily spoken of as a bond [illegible]ote, and I find that able lawyers feel that there is a substantial doubt whether a conditional-sales contract would fall within the technical, legal definition of any of the instruments which are listed in the present statute.

Senator CONNALLY. Why isn't it a note?

Mr. DORETY. I would argue that it is, Senator, but, as I say, I find sufficient doubts among lawyers about that.

Senator CONNALLY. We always find that.

Mr. DORETY. I would not advise my company to use that form of financing unless it was qualified.

Senator CONNALLY. The promise to pay in the conditional-sales contract is, in fact, a mortgage, is it not?

Mr. DORETY. That is my opinion. I think it is covered, but it is sufficiently doubtful, because of the ordinary use of the terms, that we do not feel safe.

The CHAIRMAN. Has it been taken up with the Treasury?

Mr. DORETY. It has been discussed with the chief of the taxpayers claimant's section, but he did not feel able to commit himself on the matter one way or another.

Our suggestion is that the House bill be amended by inserting in section 212 on page 207 a subparagraph or else by inserting a new section following section 212 which would insert the words, "Conditional-sales contract" or perhaps the words "Conditional-sales contract and equipment-trust certificate" following the words "certificate of indebtedness under the present act."

The question is a substantial one, because the use of these contracts, while they have been adopted to any considerable extent only in the

last year or two by railroads, there are now outstanding about $100,000,000 principal amount of them, and it is growing rapidly.

We feel that there are three good reasons why such an amendment should be adopted. In the first place, there seems to be no sound reason why this form of financing should be penalized. As the Senator points out, the conditional-sales contract has the obligation to pay principal and interest in full, just as a note or bond has, and if it is excluded it would appear to be an unfair discrimination.

Secondly, we feel that the amendment would accord what must have been the original intent of Congress, that it should be regarded as a clarification rather than an amendment. We feel that those who drafted the act must have felt either that conditional sales were known and were included in the act, or else they must have overlooked the omission entirely, because there seemed to be no sound reason for excluding this form of security.

Senator RADCLIFFE. Was there any specific discussion of the point when it was pending before the House?

Mr. DORETY. Well, Senator, not either this year or when the original act was passed. There was a provision in the original House bill which included all debt evidenced in writing or by written instrument. That was included in the original House bill in 1939 and was dropped by the Senate. Of course, that is a much wider provision than we are asking for here.

The third and most important reason for requesting the amendment is that to exclude these contracts is to penalize a form of financing that is the most economical for the railroads and would produce the largest tax collections for the Government.

Senator CONNALLY. May I ask you a question there?

Mr. DORETY. Yes.

Senator CONNALLY. As a result of the fact that the railroads have been in a bad financial condition, have been in bankruptcy, is not the sole purpose of these conditional sales contracts so as to recoup in case of a bankruptcy?

Mr. DORETY. I think not, Senator. I can only speak for my own company. The reason we have adopted it is because of its simplicity and low costs. These contracts not only avoid underwriters' charges, trustees' fees, engraving costs, and other expenses of that sort, but they reduce the total interest payments, because the principal on which interest is computed is reduced by monthly installments instead of annually or semiannually.

We compute that a conditional sales contract will cost the borrower approximately one-fourth of 1 percent a year less than an equipment trust bearing the same nominal rate of interest and for the same term.

Senator CONNALLY. Oh, yes.

Mr. DORETY. In spite of that, I feel unwilling to advise my company to continue to use that form of financing if the present law persists because of the danger of excess-profits tax. Of course to the extent that the total interest charges paid by the taxpayer are reduced, the taxpayer's deductions from income are reduced, and its ordinary income taxes are increased. So that while the Government might not collect as much excess-profits tax from the few companies who are in the excess-profits class, those companies are in the minority, and the Government would collect more ordinary income taxes from

every company using this form of financing. So that we feel that the amendment is not only just and fair and would avoid an unfair discrimination, but that it would profit the taxpayer by reducing his financing cost, and that it would profit the Government by increasing total tax collections.

Senator TAFT. I wanted to ask you how many railroads would come into the excess-profits tax class.

Mr. DORETY. I cannot answer that, Senator. I think possibly Judge Fletcher could answer it. I do not know. In fact, we do not know ourselves yet. It would depend a good deal on the terms of this final bill. I cannot say whether our company will be this year or not until this bill is passed.

It is possible you might wish to exclude small contracts for automobiles and washing machines, and that sort of thing. That, of course, can be readily done by limiting the amendment to contracts to railroad industrial equipment, or to contracts for a minimum amount like $100,000 or contracts for a specified term like 4 or 5 years.

We hope you can see your way clear to adopt the amendment in one of these forms, and I appreciate very much the privilege of presenting the matter to the committee.

Senator CONNALLY. You made a very good statement.

Mr. DORETY. Thank you.

The CHAIRMAN. Thank you very much.

Judge Fletcher, will you answer the question propounded by Senator Taft?

Mr. FLETCHER. I could not answer it, Senator, with any degree of confidence. I could only say in a general way that I think there would be quite a number in the excess-profits tax.

The CHAIRMAN. All right. Thank you very much.

Mr. Porter.

STATEMENT BY J. W. PORTER, PRESIDENT, ALABAMA BY-PRODUCTS CORPORATION, BIRMINGHAM, ALA.

Mr. PORTER. My name is J. W. Porter. I am president of Alabama By-Products Corporation, which is the largest commercial producer of coal, coke, and byproducts of coal in the Birmingham district. The company is at the present time engaged to the extent of probably 80 percent in production entering directly into the war effort. Indirectly, all of its present functions are fairly referable to the war situation. We are producing currently about 2,500,000 tons of coal annually, and about 600,00 tons of coke and resulting byproducts. We employ about 3,700 men.

My purpose in appearing before the committee is to urge consideration of a provision in the pending revenue bill that will more certainly and effectively encourage the discharge by corporations of their excess indebtedness and long accumulated interest accruals, without the tax penalties and risks which now attach.

By the 1939 amendment of section 22 (b) (9) of the Internal Revenue Code and section 19.22 (b) (9) of the income tax regulations, Congress and the Commissioner undoubtedly desired to give practical relief to corporations which had assumed in past years too heavy a burden of fixed debt. It was assumed that those corporations which

dealt with a Federal loan or regulatory agency such as the Reconstruction Finance Corporation or the Interstate Commerce Commission might readily obtain a certificate from those agencies that would permit them to exclude from gross income any profit resulting from the purchase of their bonds and accrued interest at less than face. Other corporations were required to convince the Commissioner as to their "unsound financial condition."

That term is not defined in the law. It certainly was not intended to signify insolvency, for insolvents who discount their debts and yet remain insolvent are not taxed on the discount, even without this provision.

The regulations recognize that the attitude of the public, as expressed in the market value of the securities, is primary evidence of sound or unsound financial condition. The regulations state that a corporation may be in "unsound financial condition" even though the fair market value of its assets exceeds its liabilities, and even if it is able to meet its current liabilities as they mature. They state that the fact that the corporation's bonds are selling in a free market at prices substantially below their issue and below the market price of similar issues of similar businesses is highly indicative, but not conclusive, of an unsound financial condition.

Hence, it would seem that the act as drafted and as intended by Congress and as thus liberally interpreted by the regulations, would be sufficient to permit corporations plainly overburdened with fixed charges and accumulated interest to improve their structures by purchasing their securities far below par value without incurring tax liability that would more than offset the improvement.

In practice it is certain that the statute and the regulations have not had the effect intended, since no corporation can take the risk of the Commissioner's conclusion, reached months or years after the transaction.

I am advised that only in rare instances, even in the case of the railroads, have the necessary certificates been issued. Under the procedure required as to other corporations by the Commissioner of Internal Revenue it is impracticable for any corporation to improve its position without the risk of having the benefit offset or more than offset by a tax determination which cannot be known at the time of the purchase of its obligations and may well result in a cash deficiency assessment sufficient to destroy it.

This is true for the reason that the Commissioner adheres to the conclusion that no ruling can be made, however definitely presented, prior to the examination of the return for the tax year by the internal revenue agent in charge. This fact makes the risk of adverse action too great for any corporation to encounter.

I am, of course, primarily interested in the status of my own company but its details are fairly representative. They illustrate the problem. The company was organized by merger many years ago, in boom times (1924–25) for our industry in Alabama, when we had a large market for bunker coal and had not yet met the competitive impact of fuel oil along the coast and natural gas through the heart of our market area.

The Birmingham district was producing its maximum tonnage of coal, a maximum which has never been attained even during the present war effort. The constituent companies had enjoyed several

years of fairly profitable operations. There was, accordingly, issued by the merged company, in addition to the bonds of the constituent companies assumed, an issue of income bonds, representing supposedly sound equity, amounting to $2,886,500, in addition to the equity stocks issued.

Between the years 1925 and 1932 net earnings were sufficient to pay something more than half of the interest accrued on the income bonds. Between 1932 and 1939 no payments were made on this accrual and by the end of 1939 we had outstanding on $2,886,500 principal amount of income bonds accrued interest in the amount of $1,847,490.

These bonds have been for many years purchaseable at 40 flat or less, with nothing for accumulated interest, thus clearly falling within the prime test of "unsound financial condition" meant by the statute and prescribed by the Regulations, namely, sale in a free market at prices so substantially below face and interest that the application of the statute should be undoubted. But it is not so administered.

Of course, this company is able to pay its current operating expenses as they mature and during the present period is showing a substantial operating income before taxes.

Nevertheless, as the provision in question is now interpreted and as proposed by section 112 of the House bill, which merely extends the present provision through 1945, this company and many others similarly situated are denied any practical opportunity to improve their financial structure for the grave period undoubtedly ahead of us.

My company does not occupy any unique position in this respect. I should say that more or less the same situation exists in the case of a great many, if not the majority, of locally owned corporations in the South. It is essential in the public interest that these companies be in position to square their shoulders to the shock when the tail spin sets in following the current war effort.

It will not add to post-war stability or employment if the many corporations in our area find themselves unable to cushion against the inevitable recession in business activity. We must be ready to open up new avenues, carry on research, adopt new processes and continue to give employment to our workers. We cannot do that unless we are able in a fair sense to reorganize our financial structure in a manner fully acceptable to the holders of the securities, that is by purchasing them at a discount.

As the law is now administered, we can do nothing and nobody is benefited. If a corporation reduces its bonds and fixed charges and accumulated interest as a result of formal reorganization proceedings, however drastic, I am advised that the Commissioner has ruled in advance in particular cases, based on the plan of reorganization submitted for the purpose of relieving the proposed reorganization of a risk which might have crushed it, that the resulting discharge of indebtedness would not be taxable; and later on Congress saw the necessity of making express provision to that effect in order to clarify the doubt in the case of bona fide reorganizations.

I do not believe that it should be necessary for corporations, plainly overbonded and able to retire their excess burden through purchase of their bonds and accrued interest at a heavy discount, to be forced

during these times to formal, expensive and disturbing court reorganization in order to avoid drastic tax "penalties." I think that term "penalty" is a correct term to use in connection with the administration of the present provision.

A field agent now in the office of my company is taking the position with reference to the purchase and discharge of a limited amount of our income bonds and accrued interest, acquired from the holder at 40 flat, that is $400 for a $1,000 bond, with about $500 accumulated interest, that would make the purchase cost about $1,200 after paying taxes on the transaction.

Needless to state, at present tax rates we can no longer consider that opportunity and unless Congress clarifies that situation we are going to hit the recession with unpayable debt and interest accumulations.

We earnestly hope that the committee will take the necessary action to relieve corporations in this situation. They are performing a useful function and are indispensable to post-war stability. They are now faced with the artificial prohibition which now stands in the way of necessary improvement of their financial set-up.

Under the present law my understanding is that if a taxpayer which is insolvent settles a debt for less than its face amount and still remains insolvent after the settlement, there is no taxable gain; but if the settlement restores him to solvency, he is to that extent chargeable with taxable income.

I mention this as a basis for the suggestion that it is in the public interest, for the period ahead of us, that American business organizations be definitely encouraged to strengthen their position by paying or curtailing their debts in any manner possible; and if it restores them to what the Commissioner would call solvency, so much the better.

There seems to be no controlling reason why this should be encouraged to the vague point where a corporation approaches what some revenue agent would call solvency and penalized if, according to the Bureau interpretation, it has crossed that line.

No one can guess, when the opportunity of settlement is presented, whether the Bureau would say that the company is solvent or insolvent, just as here no one can guess whether the Commissioner will, after the discharge of indebtednes has been carried out, say that the heavy debt of my corporation, with its steadily accumulating interest, places it in "unsound condition" within the long range and constructive meaning of the tax statute.

In discussing this matter with the field agent of the Bureau we have been given the definite impression that because of our relatively high operating income for current years, little of which will be retained, he would not recommend that we be given the benefit of the debt discharge amendment, although when the recession sets in we will still have the debt and the long accumulated interest. And he further advises that because our interest accumulation is not represented by a coupon, it is therefore not a security and not subject to the discharge provisions even if they applied.

These technical distinctions merely add barrier on barrier against the relief necessary to stabilize corporate structures. Debt and accrued interest menace stability, whatever their form.

Again, this field agent—and I am not criticizing his competence or his desire to be entirely fair—insists that if we discharge, by purchase

of our income bonds at below face and interest, the large amount (now 55 percent) of interest accrued and accumulated during past years, the entire interest so discharged as well as the discount on principal will be taxable income. And this notwithstanding the fact that this accrual in past years, accrued because we report on an accrual basis, was of no benefit to the company during most of the period as an income tax deduction. In short, if we took the discount, it would strangle us at 1942 or 1943 tax rates.

If stockholders waive claims against a corporation in proportion to their holdings, the forgiveness of indebtedness is generally treated as a contribution to capital. It often happens that the holders of obligations of corporations, which they are entirely willing to sell to their corporations at a discount, hold different classes of stock and in widely different proportions, and reach their conclusion to sell based on the fair market or intrinsic value of the obligation along with others who may have no stock interest in the corporation.

In these circumstances the discounts would be taxable, although in a real sense a bona fide reorganization or recapitalization is involved.

We believe that if the committee invites a reconsideration of the technical rules which now discourage the improvement of corporate solvency in connection with the aspects of the matter which I have mentioned, definite public benefit will result.

These items are generally long-held claims or long-held capital items and are from the standpoint of tax deductions in favor of the creditors of secondary or diminishing importance.

Our company is deeply concerned as to the post-war market for its byproducts. We should, as I have suggested, like to engage in research and experiment, but we are stymied against that approach by the impossibility of discharging our large accumulated debt and interest through payments entirely satisfactory to the holders of the indebtedness. That recourse would apparently subject the company to the excessive taxation of current years and leave us worse off than before.

Congress has necessarily adopted the theory of maximum taxation of income. It must operate by broad rules of general application. For that very reason, we believe that it should make every effort to enable its industrial units to get on their own feet by internal adjustments of this nature which are only in an artificial and constructive sense to be termed income.

The CHAIRMAN. Any questions, gentlemen?

If not, Mr. Porter, we thank you, sir.

Mr. PORTER. Thank you, gentlemen, very kindly.

The CHAIRMAN. Mr. Benjamin Young.

STATEMENT OF BENJAMIN E. YOUNG, DETROIT, MICH.

Mr. YOUNG. Mr. Chairman and members of the Senate Finance Committee: Gentlemen, I deeply appreciate the privilege and responsibility of appearing before you to present my views concerning the pending, highly important, tax measure upon which you now deliberate. I come before you in the same spirit as our ancestors did when presenting their views in the town-hall meetings, where a man's opinion was accepted and considered for what it was worth regardless of his position, his influence, or his income. Thus, I speak only for

myself, with a full realization of the critical position in which this country, the last great hope of democracy, finds itself. This critical period in our history and it alone impels me to appear before you at this time.

Before I undertake a discussion of the tax bill I would ask your indulgence for just a few minutes in order that I may sketch the background against which I have reviewed the subject. It seems impossible to give reasoned consideration to a new tax measure of this character without first examining and fixing in one's mind the currently existing conditions under which we live, including those which necessitate a new revenue measure. Such reflection must of necessity, take into account the Government's known fiscal policy, the methods which have been used to finance our Government of late years, the effects of such financing upon our American social, political, and economic life and the volume of new expenditures required to finance our Government with the Nation at war.

When one has studied this background to the point of having it firmly fixed in his mind and also has considered the possible effects of wartime financing, he then is in a position, I believe, better to consider all of the important questions implicit in the measure now before you, gentlemen.

I think those questions may be stated as follows:

1. First, what is the safe division between those amounts of necessary governmental expenditures which may be deferred and funded through borrowing and those which should be paid currently through taxes?

2. How may the required taxes best be levied?

3. How should the deferred amounts be borrowed?

That the fiscal policy of our Government, for many years, has been one of deficit spending is a well-known fact. This means, of course, that it has been considered unwise either to tax the people—all the people—in sufficient amount to pay for the various Government projects, or to reduce those expenditures to the point that the taxes actually levied would cover them. In this manner, the internal debt of our Government has been built up to an amount considered by many to be of staggering proportions, and this was the case even before huge additional sums were required for our war program.

Another factor, most important in its effects, is the method chosen to finance the deficit. A large share of this rapidly accumulating deficit, a share amounting already to more than $20,000,000,000, has not been financed by borrowing from our people—rather the funds have been obtained by writing up bank deposits through the process of placing Government securities with commercial banks.

Still another factor, important in its effects, is that of our Government's purchase policy with respect to silver and to gold which flowed to our country from all parts of the world. The further action of taking this huge supply of gold into our monetary system not only increased bank deposits and outstanding currency by more than $15,000,000,000 between June 30, 1933, and June 30, 1941, but also increased our monetary and banking reserves by a similar amount. It was this action which made the funding of our recurring deficits possible through placing the securities with commercial banks.

These three governmental policies have created conditions in America difficult of evaluation. But, gentlemen, it is upon this framework that we must now superimpose the financing of the costliest war in the world's history, and as you well realize, that is the monumental problem with which you are faced because of its distinct relationship to any tax measure.

May I offer some conclusions I have drawn from observation of the effects of these policies? I feel I should do this since such recommendations as I have to present before you are largely based upon my conclusions in this respect and a brief statement of them may possibly give you a measuring stick by which you may test my remarks. These conclusions are as follows:

1. The fiscal policies of our Government have had the effect of destroying the system of automatic checks and balances which historically have controlled the volume of our money. We have substituted therefor a system based upon arbitrary decision. I think most of us will agree that the old controls may have been too rigid to meet the needs of our economy in such a rapidly changing world. At the same time this breaking away has subjected us to grave dangers.

2. The departure from our previous system of checks and balances has made it infinitely easier for blocks and geographical groups to realize on their demands. Legislation for the benefit of such groups and sections has been substituted for the will of all of the people. This trend has a tendency to destroy our national unity.

3. The impact of these fiscal policies has been such that invasion after invasion has been made by the Federal Government into the rights of the people to govern themselves within the respective States; and the liberty of action of the average American individual has been progressively restricted.

4. There are two tragic consequences of this course that I particularly want to mention because of their profound effect upon the lives and well-being of each and every American, whether they are in the armed forces or are doing their part as private citizens on the home front:

(*a*) The first of these is the specter of inflation. I need not enlarge upon this because I believe the Government is wholly cognizant of its dangers, although I personally have doubts as to the soundness of steps so far taken to avoid it.

(*b*) The second is the relentless trend, wholly apart from our present war emergency during which every American freely surrenders his individual liberty of action, toward a stifling of human freedom and substituting therefor a system of governmental planning of our lives and property which will be even less acceptable to the men in the armed services when they return than it is to those of us now at home. The course which we have followed leads inevitably to these results for no people can escape them if they choose to perpetuate monetary and fiscal policies founded upon extravagance, manipulation, and confusion.

These, gentlemen, are in my opinion direct results of the fiscal policies we have been following. It is needless for me to say that the results of these policies will be greatly magnified in time of war—this obviously for the reason that while we have already spent billions of dollars in an attempt to treat our social ills, we must now spend tens

of billions for absolute military needs. So far as I can see, there is no valid reason why the tremendous resources of our Nation cannot be marshalled for these purposes and I know of no American who begrudges one single dollar spent for the vigorous prosecution of our war effort.

Nevertheless, we can more effectively battle our enemies if we quickly dispense with every policy which hampers our war effort even though we felt that such policies might have been condoned before Pearl Harbor.

The President has asked the Congress to provide for an additional 8 to 9 billions of taxes. This would make about 25 billions per year to apply against an annual expenditure of 70 billions or more. Men who are in position to make fair estimates think that 75 billions represents about the maximum we physically can spend for the Military Establishment and for the conduct of Government. In other words, we now know something of what our financial problem is. If that is our problem, I want to say that this discrepancy is too great—that the resources of even this wealthy country cannot withstand the strain of such a debt as is contemplated.

This is the first major problem before your committee—to determine how much must be raised through taxes. And I believe that if the people knew the problem with which you gentlemen are faced, if they understood it, and I believe they can understand it, they would promptly respond with their entire resources.

Certainly at this point provision should be made by Congress for raising every dollar of revenue which can be raised through taxation without permanent injury to our American way of living. I do not pretend to know just where that point lies, but I am sure that the method of approach has much to do with the distance you may go before entering the danger zone.

We all know that sacrifices are required—that sacrifice is the price of national safety. We are not afraid of that—rather we welcome it in such a cause. But we are afraid of an inexorable trend toward collectivism. We don't want our victory to be a hollow mockery.

As to taxes, there are certain facts and conditions which I would like to call to your attention. They are:

1. Taxes, I think, can best be applied for the purpose of raising revenue only. Notwithstanding all that has been said of taxation as an inflation control, I am convinced that this is true only to a minor degree for the reason that the most of our newly created increase in national income lies in the hands of farmers and workers. There is no tax schedule that can be devised which would adequately deal with the inflationary threat from this direction—there are other methods of dealing with it, however, and I hope to touch upon them at a subsequent point.

2. So far as income from the investment of capital is concerned, there is little opportunity for raising substantial amounts when compared with the magnitude of the problem, for two reasons:

(*a*) The Government's fiscal policies have already resulted in what amounts to a capital levy of 33⅓ to 50 percent in that market rates for money are controlled at a reduction in rate amounting to that approximate percentage. This applies not only to the wealthy but also to every man or women who carries a savings account or who owns an insurance policy.

(*b*) Insofar as the wealthy are concerned or insofar as individuals having high earned incomes are concerned, there, unfortunately, is little left for you to do. Surtax rates on such incomes already rest at high levels, and I am informed, although I have no way of verifying the statement, that existing death taxes in America are now the highest in the world.

So, while some additional taxes may be realized through raising existing rates on individual incomes, you undoubtedly must turn in other directions for the major amounts required. May I now discuss the details of the various classifications of taxes?

Individual income taxes.—The House has provided increases in normal and surtax rates on individual incomes and has lowered exemptions to the point that a drastic schedule has been provided. It is my conclusion that this or even a more drastic schedule may be required.

In addition, some way should be found to place the citizens of so-called community-property States on the same basis as that upon which the rest of us stand. It appears to me that the cure which has been suggested, that of penalizing certain citizens of 40 States in order to bring conformity in the other 8, is an improper approach to the problem. Some way should be found to deal with it in the 8 States involved.

The capital-gains-and-losses section of the individual income-tax schedule is, in my opinion, an unwise provision. Producing practically no income for the Government, it serves, more than any other factor I know of, to interfere with the intelligent handling of the individual's affairs and to restrain the free movement of securities and equities in our markets. A clear, concise statement in this regard was recently made by Mr. Emil Schram before the House Ways and Means Committee.

The House bill contains provisions with respect to pension trusts which severely curtail the liberty of action of a corporation in the handling of the retirement problem of certain of its employees. As a wartime measure, I agree that some restriction is necessary. May I recommend, however, that your committee look carefully into these restrictions in order to insure that pension plans, which so many corporations have provided on a company-wide basis, be not adversely affected, for these plans have been the source of great stability and independence on the part of countless retired employees, and they deserve to be continued.

Corporation taxes.—I am convinced that our entire approach to the problem of corporation taxes is wrong, but I realize that this is no occasion for a discussion of that particular subject. All that can be done in this emergency is to make the most of a difficult situation and find the maximum of additional revenue with the minimum of harm to the country's permanent business structure.

It must be remembered, however, that the money taken away from the corporation in taxes cannot also be taken away from the individuals who own the stock of that particular corporation. It must be remembered also that unless the corporation is permitted to keep a share of its earnings for growth and reserve it cannot bring forth new products and supply stable employment, nor can it pour forth a steady stream of dividends for the Government to tax in the hands of individuals.

If we could only realize it, there are no people in America whose self-interest run in any direction other than that of maintaining health and strength in our corporate business structure for the reason that we all are dependent thereon, if not for wages or dividends, then for the products produced. This was never more true than today when our need for the implements with which to fight the war can be satisfied only by the efficient performance of these combinations of men, plant, and material which we call corporations.

I should like very much to see the lottery, which is known as the declared value excess-profits tax eliminated, even if the amount is added on somewhere else.

The House provision for a 45 percent normal and surtax rate appears to me to be so high as to threaten the long-term stability of the corporate system. Smaller corporations, particularly those unable to handle war goods, will be severely affected. Realizing the great need for taxes, I think that some increase in the present over-all rate of 31 percent will have to be made. The new rate, in my opinion, should not exceed 40 percent and it would be highly beneficial were the Congress to announce that the new rate, when fixed, will apply for the duration of the war. Uncertainty as to taxes is destructive to corporate management and initiative.

As to excess-profits taxes, the 90 percent provided by the House is very stringent, even in these perilous times. Nevertheless, one might favor such a proposal were it not for its psychological effects with which you are all familiar. I believe the British have undergone an experience in that direction from which we may well learn a lesson. That experience has to do with the lack of efficiency and the disregard of costs which unconsciously crept into the operation when the profit motive was taken away.

I am familiar with the problem so many of the corporations have to face, in securing financing with which to carry on the unusual volume of war production they have undertaken and at the same time meet their income-tax assessments. I also am familiar with the extremely difficult problem laid in the laps of these corporations by your action in Congress in providing for the renegotiation of war contracts.

It may now truthfully be said that no corporation, engaged in war work, can possibly know just where it stands with reference to either profits or its financial position. I doubt if one could conceive of any greater impediment that could possibly be placed in the way of men who are managing their businesses and striving to coordinate the combinations of manpower, materials, plant, and machinery which provide the implements of war.

My conclusion is that the House proposal as to the excess-profits tax is too high. Anything over 80 percent appears certain, in the light of experience, to promote a lack of efficiency and a disregard of costs.

Other taxes.—I am not going to take your time to discuss the question of taxing State and municipal securities. This committee is quite familiar with that problem. I hope, however, that when it is considered, you will have in mind the dangers which accompany the continued invasion of State rights to which I have already referred.

The House committee gave considerable thought to including a sales tax in the bill before you. No doubt you will do likewise, because the imposition of some such tax is a practical necessity under

existing circumstances. I realize that a sales tax, once it has become part of our tax structure, will be difficult to eliminate when the emergency has passed, due to its hidden nature. Also it is impossible to apply such a tax upon the principle of the ability to pay. In addition, I think it may prove to be somewhat inflationary.

Notwithstanding these weaknesses some form of a general sales tax or an extension of our present luxury taxes to the point that they represent practically a general sales tax is undoubtedly required.

After the levy of all taxes that can be practically imposed, a wide gap between income and expenditures will still remain. I am aware that the financing of the deficit is not a subject germane to the discussion you now are conducting, but the matter is so much part and parcel of your general consideration that I ask leave to file a brief memorandum with your committee apropos thereto.

The CHAIRMAN. You may do so.

Mr. YOUNG. My purpose in bringing up this subject is to say that I believe one of the great controls which may be applied to the inflationary tendencies arising during this emergency lies in the methods which may be used to finance the deficit. I believe also that through this financing, we have a great opportunity to stabilize purchasing power during the reconstruction period after the war and, further, that the means are at hand to make countless numbers of our countrymen real "stakeholders" in the American enterprise system for the first time in their lives.

May I have your direction, Mr. Chairman, as to whether I may file this memorandum or would you direct that I read it at this point?

The CHAIRMAN. You may file it if you desire to.

Mr. YOUNG. Thank you.

It must be quite obvious to you that I am more certain of the causes for my recommendations than I am of the remedies. One cycle in our history saw economic changes come so fast that social readjustments were left far behind. The next cycle found social developments coming so fast that economic readjustments were left even further behind.

Now with the pendulum at its extreme limit, you are left with the deficit of the years preceding the war, upon which must now be superimposed the cost of the war to date and the even greater cost for the future. It is a colossal task, but one not beyond the power and the willingness of this country to meet.

The other day I lunched with officials of two great labor unions, a veteran labor conciliator, and a man who enjoys the confidence of both capital and labor. All these gentlemen were veterans of the first World War. We did not agree on everything, but each expressed his eagerness to make every sacrifice necessary to win this war.

And we had another point of agreement. We all shared the same fear—a fear of something we cannot quite place or define or express, not that we will fail to win the war, but that we might lose the peace even before we have achieved a military victory.

For my part, I believe that if we try to finance the war with an extension of the methods which have already proven unsound, we certainly not only endanger our war effort but most certainly the winning of the peace.

I feel that these methods have largely been motivated by an erroneous belief, either that they are what the people want or a fear that the people are unwilling to face the facts and pay the bill. I am quite certain that they can be convinced, that they are anxious to be taken into your complete confidence, and to make every sacrifice not only to win the war, but to lay the groundwork now for the winning of the peace and for the preservation and the advancement of both social and economic conditions, not one at the cost of the other, but both going forward together.

I thank you very much, sir, for the opportunity to present my views.

The CHAIRMAN. We thank you very much, Mr. Young. Are there any questions that any member of the committee would desire to ask Mr. Young? If not, we thank you very much.

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

MEMORANDUM ON WAR FINANCING, SUBMITTED BY BENJAMIN E. YOUNG, DETROIT, MICH.

It is my belief that the methods chosen for financing our war deficit will have much to do with the degree of price inflation we experience in America. I do not advocate that other controls be neglected, but, rather, that in the methods chosen for the financing lies the first point of attack and that this attack should be promptly launched in order that other and more direct controls may be effective.

As I view the matter, there are three factors which, taken together, will bring about a ruinous price inflation unless strenuous action of a fundamental nature is promptly undertaken and carried out. They are:

1. An overabundant supply of money. We have that condition as the result of taking into our monetary system a large percentage of the world's monetary gold and silver and as a result of financing a large portion of the depression deficit through the sale of United States Government securities to commercial banks.

2. A greatly augmented national income. We have that condition as the result of the Government's policy with regard to wages and hours of work and with regard to farm prices, together with a vastly increased degree of profitable employment; first, due to the defense preparations and, now, due to the war.

3. A shortage of consumer goods. We have that condition because the great national effort is now directed to the production of implements of war.

So, we are ripe for price inflation on the basis of present operations. But the immediate future holds even greater dangers. It is said we will spend $70,000,000,000, or thereabouts, in the 1943 fiscal year, largely on war production. Therefore, in each of the three directions just mentioned the problem becomes intensified. Regardless of taxes levied and regardless of other financing steps taken, more Government securities must be sold to commercial banks, with accompanying increases in the monetary supply; more national income will be produced as great numbers of people go to work, and less consumer goods will be available as presently existing stocks are used up.

Certain steps are being taken. Taxes on corporations and individuals, enjoying the higher incomes, have been increased and will undoubtedly be further increased to the point that little, if any, excess income will rest in their hands. In addition, attempts at rationing and price fixing are having some effect.

But the great problem remains untouched. This problem has to do with the amount of excess income, estimated by various individuals at from $20,000,000,000 to $35,000,000,000 for this year, going to farmers and workers. The increases in our national income appear to be going, almost entirely, to these groups.

One hears of numerous plans for taxing this newly found income out of their hands. Some additional taxes will undoubtedly be applied, either through lowered exemptions or through sales taxes or both. But taxes of sufficient weight to meet the inflationary threat from this direction cannot and will not be applied.

If a large share of the excess income of individuals were directed to the financing of the war, three things would be accomplished, each one vital to our American future. They are:

1. Means would be provided for financing a large share of the national deficit, thereby reducing the amount necessary to be placed with commercial banks.

2. Means would be provided for stabilizing purchasing power after the war.
3. Means would be provided for making great numbers of our countrymen real "stakeholders" in the American enterprise system, many for the first time in their lives.

A deterrent to the realization of these worth-while aims arises from the nature of our present War Savings bond contract. Such bonds are, in effect, payable upon demand.

Following is a suggestion for accomplishing these aims:

VICTORY SAVINGS BONDS

1. These bonds, bearing social-security number of purchaser for identification purposes, in addition to the Treasury serial number, would be issued at the close of the war. For farmers, domestic servants, and others not now listed, special social-security numbers should be provided. Pending the close of the war, interim certificates would be issued evidencing all payments made to the Treasury.

2. The bond would take the form of a series of 25 coupons, each covering one twenty-fifth of the principal paid in, plus accrued interest. The first coupon would fall due 6 months following the close of the war and one each 6 months thereafter until all have been retired. In effect, this amounts to a 12½-year annuity covering the period of stabilization after the war.

3. Every person receiving income would be required, for the duration of the war, to pay in a fixed percentage of his income, after Federal income taxes have been deducted and, in addition, a large percentage of his income in excess of an average based upon the years 1939, 1940, and 1941, or in excess of $1,500 for a married person or $750 for a single person, whichever is greater. It would be incumbent upon each individual to establish his base to the satisfaction of the Treasury In most cases this can be done by reference to social-security records or to income-tax returns filed for the base years.

4. The Treasury would compute the average monthly income for the base period and would require a monthly withholding, by employers, for employed persons, or a monthly payment by self-employed persons, of both the fixed percentage, and the excess-earnings percentage, so that purchasing power may be immediately, and drastically, reduced.

5. Members of the armed forces of the United States would be exempt from these requirements.

6. A relief provision would be included so that the Treasury could redeem, or authenticate for borrowing purposes, a Victory Savings bond held by one who proves, to the satisfaction of a properly constituted authority, that a dire emergency has arisen.

The CHAIRMAN. We have a communication from Mr. Rahn of Minneapolis, Minn., vice president of the Shevlin, Carpenter & Clarke Co., which will be inserted in the record, if there is no objection.

(The communication referred to is as follows:)

SHEVLIN, CARPENTER & CLARKE CO.,
Minneapolis, Minn., August 4, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR: I am vice president of the Shevlin, Carpenter & Clarke Co., of Minneapolis, Minn., operating the McCloud River Lumber Co., McCloud, Calif., and the Shevlin-Hixon Co., Bend, Oreg., each with a capacity of 150,000,000 feet of lumber.

The lumber manufacturers of the West Coast Lumbermens Association and the Western Pine Association believe that the proposed tax of 5 percent on lumber transportation, as contained in the revenue bill passed by the House, will constitute a discrimination against them, and we submit the following for your consideration.

We are not trying to avoid a tax, but we do believe that the suggestions are sound, easily worked out, and will produce more revenue more equitably with less trouble.

The statistics for class I railroads for the calendar year ending December 31, 1940, show:

	Tons terminated or delivered	Revenue	Average freight rate	
			Per ton	Per 100 pounds
				Cents
Item 430: Lumber, shingles, lath	23,253,152	$163,002,376	$7.01	35.0
Item 431: Box, crate, and cooperage material	2,046,118	12,366,459	6.04	30.2
Total	25,299,270	175,368,835	6.93	34.6

Authority: Interstate Commerce Commission Bureau of Statistics—Statement No. 41100 (17th in the series) Freight Commodity Statistics Class I Steam Railways in the United States, year ended December 31, 1940.

These figures show that for the year 1940, the railroads of the United States as a whole, received on lumber, shingles, box, crate, and cooperage material $6.93 per ton, or an average rate of freight of 34.6 cents per 100 pounds.

There has been a general increase of 6 percent on lumber freight rates since 1940. The 1940 revenue figures shown above, revised to reflect this 6 percent increase would be as follows:

	Tons terminated or delivered	Revenue	Average freight rate	
			Per ton	Per 100 pounds
				Cents
Total	25,299,270	$185,890,965	$7.35	36.8

It certainly would be more equitable in the case of lumber to make a flat charge in cents per 100 pounds. This would easily be arrived at by using the average rate of freight of 36.8 cents per 100 pounds. All freight bills show the number of pounds loaded in a car. Applying the proposed 5-percent tax to the average rate of 36.8 cents per 100 pounds, would give a tax rate of 1.84 cents per 100 pounds on all lumber terminated. We suggest a tax rate of 2 cents per 100 pounds which would produce 8 percent more revenue than is contemplated under the proposed 5-percent tax, and prevent a discrimination. The figures are shown below:

25,299,270 tons, at 2 cents per 100 pounds $10,119,708
$185,890,965, at 5 percent 9,294,548

In suggesting a rate of 2 cents per 100 pounds, it is taking into consideration the movement of logs from the woods to the sawmill. We believe that saw logs should be exempted entirely from the application of a transportation tax. For the calendar year ending 1940 the total revenue accruing to the Class 1 carriers from logs was $8,370,470. A 5-percent tax based on the 1940 revenue would produce $418,523. In proposing a flat rate of 2 cents per 100 pounds on lumber, lath, shingles, box, crate, and cooperage material, on basis of the 1940 revenue would produce $825,160 more than a 5-percent tax which would be more than sufficient to take care of the log movement. Furthermore, in connection with the movement of saw logs only a small percentage of operators use common carrier transportation facilities which would be subjected to the proposed tax. This would create a discrimination against operators using common carriers.

A tax based on a flat rate of 2 cents per 100 pounds, applied to all lumber transportation charges, regardless of its origin or destination, would create no market disturbances, would prove equitable and would raise more revenue than the proposed 5-percent tax.

The House Ways and Means Committee has already recognized the principle of a flat rate of tax in the case of coal. The bill as passed by the House provides that there shall be a tax of 5 cents per long ton of 2,240 pounds on coal; that there shall be only one tax collected. In other words, the original movement from the mine is the only one on which there shall be collected a tax.

We are not asking for relief from the tax, but merely a more equitable distribution of the same.

The application of a 5-percent tax on freight transportation charges as contained in the revenue bill passed by the House will create disturbances in lumber market relationships, as it is equivalent to a 5-percent increase in lumber freight rates, which means the greater the rate of freight the greater the amount of the tax. Lumber freight rates from western producing areas were originally established to reflect competitive market relationships between principal lumber-producing areas. This principal has been continued throughout the years. There is active competition between all lumber-producing areas.

The price of lumber at the point of consumption is the principal factor in determining what lumber shall be used. On lumber shipped from Bend, Oreg., or McCloud, Calif., the transportation cost is a very substantial percentage of the f. o. b. mill value. In some instances on the lower grades of lumber the cost of transportation has exceeded the f. o. b. mill value of the product itself as shown in the following table:

Relationship of transportation charges to the mill value of the product shipped from Bend, Oreg., or McCloud, Calif., to Detroit, Mich.

Ponderosa pine	Delivered price per 1,000 feet, board measure	F. o. b. mill price per 1,000 feet, board measure	Freight 1,000 feet, board measure	Freight cost as compared with f. o. b. mill value
				Percent
1 by 2 inches random lengths, No. 3	$47.50	$31.00	$16.50	53.32
1 inch random widths, random lengths, No. 4	38.50	22.00	16.50	75.14
1 inch random widths, random lengths, No. 5	30.50	14.00	16.50	118.07

The production by grades for the year 1941 was as follows:

McCloud, Calif.	*Bend, Oreg.*
47½ percent No. 2 and Better	33½ percent No. 2 and Better
52½ percent No. 3 and Poorer	66½ percent No. 3 and Poorer

Lumber from the Western Pine Association and West Coast Lumbermens Association is shipped on much higher rates of freight than from mills in producing areas located closer to the large points of consumption, such as Chicago, Ill.; Detroit, Mich.; and Buffalo and New York, N. Y.

During the present period of strong demand and ceiling prices, this means the consumer who has to pay the high freight charge is penalized as against the consumer with low freight rates. A percentage increase either for freight charge or tax further accentuates the discrimination. In a period of light demand and low competitive prices any percentage increase in fixed costs discriminates against the manufacturer who ships on a high freight rate as against the shipper with the short rate of freight.

The following are examples of present comparative freight rates on lumber of representative shipping points:

To—	Southern pine from Alexandria, La.	Ponderosa pine from Bend, Oreg., and McCloud, Calif.
	Cts. per 100 lb.	*Cts. per 100 lb.*
Chicago, Ill.	43	78
Detroit, Mich.	45	87
Buffalo, N. Y.	49	87
New York, N. Y.	50	87

On basis of today's ceiling prices, the delivered prices in Detroit, Mich., on competitive items, using southern yellow pine No. 2, and ponderosa pine No. 3, boards, 1 by 12 random lengths, are:

	Ceiling price, f. o. b. mill, per 1,000 feet, board measure	Freight to Detroit, Mich., per 1,000 feet, board measure	Delivered price at Detroit, Mich., per 1,000 feet, board measure
Alexandria, La	$33.00	$11.25	$44.25
Bend, Oreg	31.00	16.50	47.50

If a 5-percent tax on transportation were put into effect as proposed, the following would be the result on the same item:

	Ceiling price f. o. b. mill, per 1,000 feet, board measure	Freight and 5 percent tax to Detroit, Mich., per 1,000 feet board measure	Delivered price at Detroit, Mich., per 1,000 feet board measure
Alexandria, La	$33.00	$11.71	$44.71
Bend, Oreg	31.00	17.33	48.33

If a tax of 2 cents per 100 pounds were applied instead of a 5-percent tax, the following would be the result on the same item:

	Ceiling price f. o. b. mill, per 1,000 feet board measure	Freight and tax at 2 cents per 100 pounds to Detroit, Mich., per 1,000 feet board measure	Delivered price at Detroit, Mich., per 1,000 feet board measure
Alexandria, La	$33.00	$11.75	$44.75
Bend, Oreg	31.00	16.88	47.88

A percentage tax is in fact a percentage increase in freight rates, and is a further discrimination.

Lumber is a commodity that must be secured from the source where the timber is grown. It is unlike many commodities in this respect, the manufacturer having no control over the location of his raw material. The manufacturer must go where the raw material (trees) grows.

The Pacific Northwest and California manufactures more lumber than any other producing region. The largest stands of virgin timber are located in that area. The lumber freight rate from that area is substantially higher than the rate from any other lumber producing region.

We hope, as chairman of the finance committee, you will submit this letter to your whole committee for serious consideration, filing for committee print (without witnesses being present), and take action to eliminate the discriminatory effect of a 5-percent tax.

I am sending a copy of this letter to each member of the Senate Finance Committee so they may have an opportunity of acquainting themselves with our proposal.

Very truly yours,

A. A. D. RAHN.

The CHAIRMAN. The committee will recess until 2 o'clock.

(Whereupon, at the hour of 12:22 p. m., the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

Whereupon, at 2 p. m., the committee met, pursuant to recess.)

STATEMENT OF WILLIAM F. MORTON, BOSTON, MASS., VICE PRESIDENT, STATE STREET INVESTMENT CORPORATION

The CHAIRMAN. Are you here on regulated investment companies?

Mr. MORTON. Yes, sir.

The CHAIRMAN. Are there any others?

Mr. MORTON. There are three others. There are a group of four of us who are to testify. My own appearance will take not more than 10 minutes, and the group as a whole shouldn't take more than 35 or 40 minutes.

The CHAIRMAN. Aren't you all on the same points?

Mr. MORTON. No; we are not, sir.

The CHAIRMAN. All right. Proceed. Let's travel as fast as we can.

Mr. MORTON. My name is William F. Morton. I am a vice president of the State Street Investment Corporation, located in Boston. I am appearing for a group of open-end investment companies and I wish to propose an amendment to section 151 of the House bill, that I believe has the concurrence of the entire industry.

The CHAIRMAN. Is this the old fight between the open end and closed fellows?

Mr. MORTON. No, sir. My next sentence covers that.

The CHAIRMAN. I shouldn't be anticipating.

Mr. MORTON. I believe that my amendment which I am offering has the concurrence of the entire industry. I will cover that more in letail in a moment.

An open-end company by definition of the Investment Company Act of 1940 is a company which issues redeemable shares. A closed-end company is one whose shares are not so redeemable.

Section 151 of the House bill contains a revision of supplement Q of the Internal Revenue Code. Supplement Q is the continuation of a provision first included in the 1936 Revenue Act for the taxation of mutual-investment companies, a mutual company as there defined being an open-end company which complies with certain standards there prescribed. The essence of supplement Q is that it treats such a company as a "conduit" and grants to it a credit for dividends paid in lieu of a credit for dividends received, with the result in general that the net income received and then distributed is taxed to the shareholder and not to the company, which is regarded in substance merely as a managing agent for the shareholders.

The House bill amendments to supplement Q contained in section 151 are three: First, it broadens the definition of companies to which it is applicable to include additional investment companies regulated under the Investment Company Act and calls them "regulated" instead of "mutual" companies. The broadened definition includes closed-end companies as well as open-end companies.

Second, it applies to any net income that is not distributed, the new rates applicable to all corporations.

Third, it applies to capital gains if undistributed, the effective rate applicable to capital gains of all corporations.

We have no criticism of these changes as contained in the House bill and we approve these changes. There is, however, another change of great importance elsewhere in the Revenue bill which has a peculiar effect on the taxation of investment companies and in the opinion of the entire industry requires some further modification of Section 151.

I would like to introduce the amendment which covers this particular situation, which I am offering at this time.

The CHAIRMAN. Yes, sir. You may put that in the record.

(The amendment referred to is as follows:)

PROPOSED REVISION OF SECTION 151 OF THE REVENUE BILL OF 1942

SEC. 151. REGULATED INVESTMENT COMPANIES.—(a) DEFINITION AND RATES OF NORMAL TAX AND SURTAX.—Supplement Q of chapter 1 is amended to read as follows:

"SUPPLEMENT Q. REGULATED INVESTMENT COMPANIES

"SEC. 361. DEFINITION.—(a) IN GENERAL.—For the purposes of this chapter, the term 'regulated investment company' means any domestic corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 501, which at all times during the taxable year is registered under the Investment Company Act of 1940 (54 Stat. 789, 15 U. S. C., 1940 ed., secs. 80 (a) (1) to 80 (b) (2)), or that Act as amended, either as a management company or as a unit investment trust.

"(b) LIMITATIONS.—Despite the provisions of subsection (a), a corporation shall not be considered a regulated investment company for any taxable year unless—

"(1) At least 90 per centum of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities; and

"(2) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than three months; and

"(3) At the close of each quarter of the taxable year (A) at least 50 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other regulated investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of the taxpayer and to not more than 10 per centum of the outstanding voting securities of such issuer, and (B) not more than 25 per centum of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Commissioner with the approval of the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses. For the purposes of clause (B), in ascertaining the value of the taxpayer's investment in the securities of an issuer, there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Commissioner and approved by the Secretary. The term 'controls', as used in this paragraph, means the ownership in a corporation of 20 per centum or more of the total combined voting power of all classes of stock entitled to vote. The term 'controlled group', as used in this paragraph, means one or more chains of corporations connected through stock ownership with the taxpayer if (i) 20 per centum or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and (ii) the taxpayer owns directly 20 per centum or more of the total combined voting power of all classes of stock entitled to vote, of at

least one of the other corporations. The term 'value' as used in this paragraph means, with respect to securities (other than those of majority-owned subsidiaries for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher. All other terms used in the preceding provisions of this paragraph shall have the same meaning as when used in the Investment Company Act of 1940, or that Act as amended. A corporation which meets the foregoing requirements of this paragraph at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within thirty days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for the purposes of applying the preceding sentence. A corporation which meets such requirements at the close of its first quarter after the date of the enactment of the Revenue Act of 1942, or eliminates any discrepancy between the value of its investments and such requirements existing at the close of such quarter within thirty days thereafter, shall be deemed to have met such requirements at all previous times; and

"(4) In the case of an investment company organized prior to January 1, 1942, which for no year prior to the taxable year has claimed in its return to be subject to tax under Supplement Q or the corresponding provisions of a prior revenue law, it files with its return for the taxable year an election to be a regulated investment company for such taxable year and all subsequent taxable years.

"SEC. 362. TAX ON REGULATED INVESTMENT COMPANIES.—(a) EARNINGS AND PROFITS.—Any expenditure paid or accrued or loss sustained by a regulated investment company for any taxable year beginning after December 31, 1941, which is not allowable as a deduction in the computation of the net income of such taxable year, shall not enter into the computation of its earnings and profits of the taxable year.

"(b) METHOD OF TAXATION OF COMPANIES AND SHAREHOLDERS.—In the case of a regulated investment company which distributes during the taxable year to its shareholders as taxable dividends other than capital gain dividends an amount not less than 90 per centum of its net income computed without regard to a net long-term and net short-term capital gains, and complies with all rules and regulations prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock:

"(1) Its Supplement Q net income shall be its adjusted net income, excluding the excess, if any, of the net long-term capital gain over the net short-term capital loss, computed without the net operating loss deduction provided in section 23 (s), minus the basic surtax credit, excluding capital gain dividends, computed under section 27 (b) without the application of paragraphs (2) and (3). For the purposes of this subsection, the net income shall be computed without regard to section 47 (c).

"(2) Its Supplement Q surtax net income shall be its net income, excluding the excess, if any, of the net long-term capital gain over the net short-term capital loss, computed without the net operating loss deduction provided in section 23 (s), minus the dividends other than capital gain dividends paid during the taxable year increased by the consent dividends credit provided by section 28. For the purposes of this subsection the amount of dividends paid shall be computed in the same manner as provided in subsections (d), (e), (f), (g), (h), and (i) of section 27 for the purpose of the basic surtax credit provided in section 27. For the purposes of this subsection the net income shall be computed without regard to section 47 (c).

"(3) There shall be levied, collected and paid for each taxable year upon its Supplement Q net income a tax equal to 24 per centum of the amount thereof.

"(4) There shall be levied, collected and paid for each taxable year upon its Supplement Q surtax net income a tax of 21 per centum of the amount thereof.

"(5) There shall be levied, collected and paid for each taxable year a tax of 25 per centum of the excess, if any, of the net long-term capital gain over the sum of the net short-term capital loss and the amount of capital gain dividends paid during the year.

"(6) Capital gain dividends shall be included in the returns of shareholders as gains from the sale or exchange of capital assets held for more than 15 months.

"(7) A capital gain dividend means any dividend or part thereof which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders at any time prior to the expiration of thirty days after the close of its taxable year; provided however that, if the aggregate amount so designated is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, computed as of the end of the year, without regard to the amount of gain or loss at the time of distribution, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount designated as such which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

(b) TECHNICAL AMENDMENTS.—(1) Section 4 (relating to applicability of supplements) is amended by striking out "(j) Mutual investment companies, Supplement Q" and inserting in lieu thereof "(j) Regulated investment companies, Supplement Q."

(2) Section 14 (e) (relating to tax on corporations) is amended to read as follows:

"(e) REGULATED INVESTMENT COMPANIES.—In the case of a corporation subject to the tax imposed by Supplement Q the tax shall be as provided in such supplement."

(c) RETROACTIVE PROVISIONS RELATING TO EARNINGS AND PROFITS.—For any taxable year beginning after December 31, 1935, and before January 1, 1942, of a corporation which filed an income tax return as a mutual investment company, the amount of net capital loss of such corporation recognized in excess of the amount thereof allowed in computing its net income for such year shall not enter into the computation of its earnings and profits of the taxable year except that such elimination of net nondeductible losses shall not result in earnings and profits of the taxable year in excess of the aggregate of the distributions made by the corporation to its shareholders during the taxable year exclusive of the amounts, if any, which the corporation advised its shareholders to be nontaxable for federal income tax purposes.

(Sec. 153 of the revenue bill of 1942 should omit "362" and "363" in sec. 117 (c) (1).)

Mr. MORTON. The change in the general law which requires a modification of section 151 of the House bill which I have referred to is one applicable to all corporations, whereby net capital losses are to be no longer deductible in the computation of net income. I am not criticizing this provision of the House bill, I am assuming it; but it changes materially the existing provisions of supplement Q. One of the requirements of supplement Q is that an investment company in order to come under it in any year must distribute at least 90 percent of its net income as taxable dividends. Now, under the general provisions of the House bill net capital losses, although they don't reduce net income, do reduce "earnings and profits" and accordingly may make impossible the distribution of a taxable dividend. So, if a company has net losses equal to more than 10 percent of its net income, even though it distributes the whole of its net income, it has failed to distribute as much as 90 percent thereof in the form of taxable dividends and is therefore disqualified as a regulated investment company.

The practical effect of this on different segments of our industry is variable. It is much more severe in the case of companies whose investments are largely in bonds than upon those whose investments are

principally in stocks; but it is bound to have this over-all effect, that a very large percentage of investment companies will be disqualified from supplement Q—the companies themselves will be subject to tax as ordinary corporations and their shareholders will be in whole or in part exempt from taxation on the dividends which they receive—which is the exact opposite of the result which supplement Q was intended to achieve.

To cure this situation we suggest that in the case of all investment companies taxable under supplement Q, the net capital losses be excluded from the computation of earnings and profits of the taxable year, as well as from the computation of net income. Thus all distributions of net income will be in the form of taxable dividends and supplement Q will work as it was intended to. Under our amendment, this treatment would apply for all companies which have been taxed under supplement Q in the past plus those which qualify and are to be taxed under supplement Q in the future.

As a corollary to this treatment of net capital losses, our amendment provides that long-term capital gains that are distributed to shareholders in the year in which they are realized shall be taxed to shareholders as long-term capital gains rather than as ordinary dividends. This is a logical application of the conduit theory underlying supplement Q. It may be observed that this treatment of distributed capital gains is essentially the same as that provided in the case of common trust funds which are a kind of investment company operated by banks.

Our amendment is a sound and practical adaptation of supplement Q to the new situation resulting from the proposed changes of the House bill with respect to capital gains and losses. It has been submitted to a great many companies, open-end and closed-end alike, those investing in bonds, and those investing in stock, and those investing in varying proportions in both bonds and stocks. So far as we have been able to ascertain our proposal is acceptable to all of the companies in the industry. We know of no company which objects in any way.

We have also consulted Treasury officials and particularly appreciate the time and attention that is being given to this problem by Mr. Surrey and Mr. Freyburger, of the Treasury, and their associates.

We request your consideration of our amendment. We are convinced it is necessary to allow supplement Q to work as intended, to achieve fair and equitable results for our investors, the companies, and the Treasury.

The CHAIRMAN. Have you additional copies of the amendment?

Mr. MORTON. I have one additional copy here.

Senator TAFT. The clerk will make copies.

The CHAIRMAN. Suppose you take it, Senator Taft. Have you talked with Mr. Stam?

Mr. MORTON. No; we have not, sir.

The CHAIRMAN. You haven't talked with him?

Mr. MORTON. No.

The CHAIRMAN. I would like to have an additional copy made. Have the clerk make it. Turn it over to him.

Mr. MORTON. I have one additional copy here, and will be very glad to leave it [handing].

The CHAIRMAN. Thank you.

Mr. MORTON. Thank you, sir.

The CHAIRMAN. Mr. Sholley.

STATEMENT OF S. L. SHOLLEY, BOSTON, MASS., PRESIDENT, KEYSTONE CUSTODIAN FUND, INC.

The CHAIRMAN. Mr. Sholley, you are on the same general question of regulated investment companies?

Mr. SHOLLEY. Yes, sir.

The CHAIRMAN. All right. You may proceed.

Mr. SHOLLEY. Thank you.

My name is S. L. Sholley. I am president of Keystone Custodian Fund, Boston, Mass. I am appearing here primarily on behalf of all investment companies owning bonds. I wish to endorse the remarks of the previous speaker and the amendment which he has submitted for your consideration.

Some of these investment companies confine their investments exclusively to bonds. Others own bonds and stocks. Many of them today own stocks exclusively, but may at some future time wish to put a portion of their capital in bonds.

Naturally, under present circumstances, many investment companies have increased their holdings of Government bonds. These funds represent the interests of thousands of investors having an average investment of $1,000 to $2,000, who, because of their modest amounts of capital individually have pooled their resources in investment companies to gain the advantages of diversification and experienced supervision which large investors are able to obtain on their own account. Thus the mutual investment companies comprising stock, bonds, and balanced funds, supply a needed service to the small investors throughout the country, many of them are women.

Like banks, investment companies have been recognized as public fiduciaries and taxed under separate provisions of past revenue acts and under supplement Q of the Internal Revenue Code.

This section of the revenue act aims to avoid double taxation on the small investor by providing that a mutual-investment company receives a dividend paid credit for the income distributed to investors as a taxable dividend. In other words, the investment company act as a conduit or agent for a large group of small investors. The company passes the investment income along to the investors who pay the taxes as though they owned the securities directly. Double taxation is avoided by giving the company a dividend paid credit for the income that flows through to the individual investor.

The immediate problem of the investment company owning bonds, or contemplating the purchase of bonds, arises from the fact that the House version of the new revenue law disallows long-term capital losses in the computation of net income and the corollary correction has not as yet been made in supplement Q. This disallowance of long-term losses may under certain circumstances make it technically impossible for the company to qualify under supple-

ment Q and in this event will subject it to the double taxation that this section of the tax law intends to eliminate.

Such technical disqualification would be serious for a fund owning stocks, but it is even more serious for a fund owning bonds, because the dividend received credit available to all corporations does not apply in the case of bond interest.

If a fund has $100,000 of net income from bond interest and is disqualified under supplement Q because of unallowable long-term losses, the whole $100,000 would be subjected to a full corporate tax. At 45 percent, this takes $45,000. When the remaining $55,000 is then distributed to the investors, the portion representing earnings and profits would againg be taxed at full individual rates. Thus double taxation might take from half to three-quarters of the entire income, the fund would be forced out of existence and the investors would be deprived of a needed service.

A law that is intended to—and in fact does—relieve the small investor of double taxation in years in which he has income and profits should not work to impose double taxation in years in which he has losses.

In the management of any extensive investment portfolio some losses are inevitable, and in the case of open-end investment companies such losses may arise from the ordinary daily transaction of its business. Open-end investment companies issue and redeem their shares as a routine part of their daily operations and the inflow and outflow of capital is determined by the public. Some companies are permitted to carry cash but others have no such discretion. Like a bank they accept deposits and honor withdrawals with no control over either. If capital is flowing into the fund, it must be invested to produce income for the investors; if it is flowing out, securities must be sold to redeem shares, and if redemption develops in volume when market prices are at a relatively low level, the fund may be required to sell securities at a loss to meet these liquidations. Thus, in such an open-end company, losses on the sale of securities to provide cash to pay off shareholders for their certificates, when tendered, are involuntary rather than voluntary. It is something over which such an open-end trust has no control.

This untenable situation is resolved by the suggested amendments which have been submitted by Mr. Morton for the consideration of your committee.

These amendments eliminate the possibility of the disqualification of a regulated investment company because of unallowable losses and make it possible for the company to distribute the income to investors as a taxable dividend, thereby complying with the conduit theory of supplement Q.

The CHAIRMAN. Without going into the technical amendment, what does it do? Does it undertake to redefine net income?

Mr. SHOLLEY. No; it redefines earnings and profits so that this gap cannot develop.

The CHAIRMAN. So that this capital loss——

Mr. SHOLLEY. Can't reduce earnings and profits. Therefore, it makes it possible to distribute the entire income as a taxable income.

The CHAIRMAN. All right. Proceed. It looks to me like you have got a very good point. Probably it was not intended to subject you

there to the double taxation. Maybe in writing the statute, they simply overlooked this.

Mr. SHOLLEY. I think the change was probably made, sir in the general law without realizing its effect on the section of supplement Q. It brings you out to an entirely different result than the result intended, unless the corresponding change is made.

The CHAIRMAN. All right.

Mr. SHOLLEY. The amendments also provide that the income passed along by the regulated investment companies be identified as to source; that is, ordinary income or capital gains, so that the investor pays his tax as he would if he owned the securities directly, again in accordance with the conduit theory.

It is earnestly requested that these amendments be adopted for the following reasons:

1. To protect bond and balanced funds that are now serving more than 50,000 investors of moderate means from the hazard of being forced out of business because of a technicality.

2. To make it practical for investment companies to continue to invest in bonds, and

3. To allow supplement Q to work as it was intended to work; namely, to avoid double taxation but to make the distribution taxable in the hands of the investor substantially as though he owned the securities directly.

The CHAIRMAN. Thank you very much. Are there any questions? (No response.)

Mr. SHOLLEY. Thank you.

The CHAIRMAN. Mr. Jaretzki.

I did not call Mr. Berlack's name.

Mr. BERLACK. I notified the clerk that I didn't desire to make a statement. What I desired to say has been or will be covered by the other speakers.

The CHAIRMAN. That is my understanding. Thank you.

All right, Mr. Jaretzki.

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 firm of Sullivan & Cromwell of New York, and I am appearing on behalf of a group of investment companies of the closed-end type. I am representing closed-end companies and it has been the open-end companies that have spoken heretofore.

I appeared before this committee last summer and urged the enactment of tax provisions for closed-end investment companies comparable to those applicable to open-end companies under supplement Q. At that time I felt that the committee fully appreciated our problem, but it was apparent that full consideration of the matter would have to await the present revenue bill, and because this matter has been gone into before, I am not going to repeat what I presented to this committee before. Appropriate provisions have been included in the House bill, which extend the provisions of supplement Q to diversified investment companies of the closed-end type.

The provisions of the House bill meet our situation. Nevertheless, we recognize the problems faced by the open-end companies as outlined by the previous witnesses. In order to achieve a comprehensive solution of the tax problems of the industry as a whole recognition must be given to the special circumstances of its component parts. With this in mind, the amendments as filed by Mr. Morton with section 361 (b) (4), which permits closed-end companies to avail themselves of its provisions, are acceptable to us.

The CHAIRMAN. Thank you.

Mr. Higgins.

STATEMENT OF ALLAN H. W. HIGGINS, OF GOODWIN, PROCTER & HOAR, BOSTON, MASS.

Mr. HIGGINS. Mr. Chairman and Senators: I think I might say before I proceed on this one point here that Mr. Morton was unaware that I had discussed this major problem with Mr. Stam and submitted the memorandum to him in connection with this question.

My name is Allan H. W. Higgins. I am a member of the law firm of Goodwin, Procter & Hoar, of Boston. I am appearing on behalf of various mutual investment companies and particularly those interested in one part of the amendment which has been submitted, which provides for retroactive relief from taxes imposed on account of a technicality in years which they were deficit corporations. The House bill has granted such relief to personal holding companies and companies under the undistributed-profits tax.

Personal holding companies and corporations under the undistributed-profits tax, like mutual investment companies, receive a dividend paid credit if they pay out all or a part of their net income as taxable dividends. If they fail to qualify then they lose their dividends paid credit and are subjected to a tax which amounts to a penalty.

In years in which they had deficits, some of these companies made distributions as taxable dividends and claimed a dividends paid credit. Later the taxability of the dividends was questioned for some reason, and the company was disqualified and found itself in just as bad a position as it would have been if it had paid no dividend. The Treasury Department and the House recognized this inequality and in the House bill provided relief to personal holding companies and deficit corporations under the undistributed-profits tax, but apparently inadvertently omitted the relief to mutual investment companies. Such relief is now requested to correct this inequity.

The situation with respect to mutual investment companies presents an even greater hardship than in the case of the companies which have already been granted relief, due to the fact that because of the redemption feature, the losses of mutual investment companies are not controllable and also because, in order to qualify, mutual investment companies are required to distribute 90 percent of their net income as taxable dividends.

The previous speakers have indicated that just a very slight excess of nondeductible losses might disqualify the company and deprive it of its dividends paid credit. Various cases have arisen where unex-

pected losses or slight adjustment of losses have caused such a serious injustice. For example, a company which had a deficit, but believed it qualified as a mutual investment company, paid 90 percent of its net income to shareholders and advised them that the dividend was taxable. Subsequently a revenue agent makes an adjustment increasing its losses. The earnings and profits are thereby reduced so that although the company distributed 90 percent of its net income, it was not all from earnings and profits and could not be a taxable dividend. This company is now in danger of losing its dividends-paid credit and being subjected to a substantial corporate tax which was never contemplated in supplement Q.

Such a company did everything it could to qualify, believed it had, and then, on a technicality, gets disqualified and is subjected to a tax which was not expected and which is grossly unfair not only to the company but to its shareholders.

This situation can only be corrected by a relief provision similar to that granted to personal-holding companies and other deficit corporations. The revision of section 151 of the House bill submitted by the previous speaker, Mr. Morton, includes such a proposed retroactive relief provision for mutual investment companies and is designated as section 151 (c).

The proposed relief provision is applicable only where a company filed its income tax as a mutual investment company, paid what it believed to be a taxable dividend and claimed the dividends paid credit. Presumably the stockholders treated the dividend as taxable and paid a tax thereon. In such a case even though disallowed losses of the corporation might otherwise reduce its earnings and profits, nevertheless, under the amendment, the corporation would receive the dividends paid credit.

It is submitted that this result is fair and equitable to both the investment companies and the Government and we trust that the relief section which we have submitted or an equivalent will be adopted by your committee.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you very much.

Mr. HIGGINS. Thank you.

The CHAIRMAN. Mr. Patton.

STATEMENT OF THOMAS F. PATTON, CLEVELAND, OHIO, REPRESENTING REPUBLIC STEEL CORPORATION

Mr. PATTON. Mr. Chairman, my name is Patton. I am appearing here on behalf of Republic Steel Corporation. I have about a 20-minute statement.

Mr. Boyer, vice president and comptroller of the company is with me and he is intimately familiar with the tax and financial problems of the company. If, at the conclusion of the statement, you would like to ask any questions, between us, we will try to answer them.

The CHAIRMAN. You may proceed.

Mr. PATTON. Republic Steel Corporation is the third largest steel company in the country. It operates steel and manufacturing plants, mines, and warehouses throughout the United States. These facilities

are today running at unprecedented rates in the production of materials for use in the construction of tanks, airplanes, ships, guns, and similar equipment essential to the successful prosecution of the war.

The company at present employs approximately 68,000 persons and has more than 62,000 stockholders, 48,000 of whom own 50 shares or less. The welfare of the company is of vital concern to all the employees and stockholders of the company, to their families and to the communities in which the company's operations are located.

Republic Steel Corporation, as presently organized, dates from April 1930. As of January 1, 1942, it had a capitalization of approximately $350,000,000 representing investment by holders of bonds, preferred and common stock. In the period 1930 to 1941, inclusive, the company spent $122,287,000 on new construction and property improvements, the larger part of which represents borrowed capital. The funded debt of the company as of January 1, 1942, amounted to approximately $95,000,000. This debt must by contract with the holders thereof be retired at the rate of over $5,000,000 per year.

We, in Republic, have a full appreciation of the need for unprecedented amounts of revenue to carry on and win the war. We also appreciate the complexity of the problem involved in the enactment of a revenue bill which will produce the utmost in revenue and yet be compatible with the preservation of a sound economy. Nevertheless, we feel that the tax bill enacted by the House of Representatives contains certain inequities which will work undue hardship on Republic, its stockholders and employees. We shall now explain to you what these inequities are and shall suggest methods by which they may be corrected.

The first point we wish to urge upon you is that the gradation of the excess-profits credit, based upon size, is unfair. The revenue bill as presently written provides for an 8-percent credit against excess-profits taxes on invested capital up to $5,000,000; for a credit of 7 percent on invested capital between $5,000,000 and $10,000,000; of 6 percent between $10,000,000 and $200,000,000, and of 5 percent on invested capital over $200,000,000.

In our judgment there is no fairness in, nor reason for this gradation. In effect, it discriminates against the stockholders of large companies, such as Republic, in favor of the stockholders of smaller companies. To illustrate in a practical way: If a small company engaged in the steel business, having an invested capital of $5,000,000 owned a single bar mill or sheet mill, it would be permitted to retain earnings of 8 percent on its invested capital free from any excess-profits tax. If, on the other hand, a mill or mills of exactly the same character were owned by Republic, along with many other mills, Republic would only be entitled to retain 5 percent on the capital invested in such mills free from excess-profits tax. Thus in Republic's case the net earnings of such mills after taxes would be less simply and solely because of Republic's size. This is not sound economics.

The stockholders of companies are the real parties at interest where corporate taxes are concerned. There is no reason either in justice or logic why a stockholder should be penalized simply because he holds stock in a company with a large invested capital instead of stock in a company with a small invested capital. Yet this is the net

effect of the present proposal. In this respect the stockholders of Republic, many of whom are women, elderly persons, colleges, and hospitals, suffer along with all other stockholders of other large companies.

Republic, with invested capital in the neighborhood of $300,000,000 is owned by some 62,000 stockholders, the average of whose holdings is between $4,000 and $5,000 each. The invested capital credit as proposed on $300,000,000 is at an over-all rate of 5.7 percent. If the company had only $200,000,000 invested capital, the invested capital credit would be at an over-all rate of 6.075 percent. Likewise, a $100,000,000 company would have an over-all rate of 6.15 percent; a $10,000,000 company would have an over-all rate of 7.5 percent; and a $5,000,000 company would have an over-all rate of 8 percent. Thus the $5,000 stockholder in the larger company is placed at a disadvantage compared to the $5,000 stockholder in the smaller company, solely on account of the relative size of the companies.

Modifications of tax rates have been made to lighten the burden of tax on smaller companies. Here, however, we are dealing with an excess-profit credit to determine what are the excess profits, and the stockholder who has invested in the larger company finds that what are excess-profits to him are normal profits to his neighbor whose investment is in a smaller company. This discrimination affects adversely hundreds of thousands of stockholders who own the stocks of our large publicly owned companies.

We strongly urge that the proposed gradation be eliminated and that the credit on all invested capital be fixed at 8 percent. The resulting yield from so-called "normal profits" after the application of the normal tax and surtax would be 55 percent of 8 percent, or 4.4 percent on invested capital. Surely that is not too high.

The second point we desire to urge upon you is the inequity in reducing the invested capital credit. In adopting the excess profits tax under the Second Revenue Act of 1940, Congress characterized excess-profits as the amount of profits after deducting normal income tax and in excess of a defined excess-profits-tax credit. The excess-profits-tax credit provided for was either 8 percent of invested capital or 95 percent of average earnings after normal income tax for a base period of 4 years—1936 to 1939, inclusive.

In the steel industry in general, and in the case of Republic in particular, the base period earnings were substandard and the invested capital basis offered the only reasonable excess-profits-tax credit. When the Revenue Act of 1941 was enacted, it was provided that excess profits would be determined and the excess-profits tax applied before the deduction of normal income tax. In recognition of this change, the allowable excess-profits-tax credit based on "average earnings" was appropriately increased to 95 percent of the base period earnings before normal invome taxes—an increase of approximately 20 percent. As opposed to this increase, the excess-profits-tax credit based on invested capital was reduced to 7 percent on all capital in excess of $5,000,000—a reduction of approximately 12 percent.

The proposed new tax for 1942 logically allows the same excess-profits-tax credit, based on average earnings for the base period, as was allowed under the Revenue Act of 1941. But the excess-profits-tax credit based on invested capital is again reduced to a graduated

scale of 8, 7, 6, and 5 percent of capital invested. For a company with $300,000,000 invested capital, this is a further reduction of approximately 18 percent.

Thus, since the enactment of the first excess-profits-tax law in 1940, the credit to companies on an average-earnings basis has increased, whereas the credit to companies using the invested-capital method has consistently and substantially decreased.

The increases in excess-profits-tax rates from a maximum of 60 percent in 1941 to a flat rate of 90 percent in 1942 accentuate the hardship upon and discrimination against the company whose excess-profits-tax credit must be based on invested capital.

A further discrimination against the companies whose excess-profits-tax credit is figured on the basis of invested capital is in the allowance on new invested capital. In the case of a company like Republic Steel Corporation with some $300,000,000 invested capital, the additional allowance on invested-capital credit for new capital is 5 percent under the proposed new law, whereas 8 percent would be allowed on new capital if the company were on an average-earnings basis, or had low invested capital.

The next point we desire to urge upon the committee is that income used for debt retirement should be exempt from tax.

A company such as Republic must have some surplus earnings to retire its debt, and at the same time have funds available to make construction expenditures to meet technical and trade requirements, to pay a moderate return to its stockholders, and to have some balance to carry over for loss years. In 1931 and 1932, Republic had a loss totalling more than $20,000,000.

Following are the salient figures on Republic's operations for the first 6 months of 1942:

Sales	$252,201,000
Profit before Federal income and excess-profits tax	43,872,000
Federal income and excess-profits tax (estimated)	35,800,000
Net income	8,072,000

As heretofore stated, Republic is required by contract to retire each year over $5,000,000 of its approximately $95,000,000 of outstanding debt.

The proposal for a graded excess-profits tax base of 8, 7, 6, and 5 percent will reduce the earnings of Republic to a point which will make it very difficult for it to carry out its obligations for debt retirement and at the same time have funds available for the other purposes I mentioned.

We particularly call your attention to the requirements for new construction, the larger part of the funds for which must be borrowed.

In the year 1937 Republic expended more than $39,000,000 for new furnaces, mills, and equipment, and in the period 1940–41, it expended $39,500,000 for new construction and equipment. Some of these expenditures were for furnaces and mills which are today, in this critical war period, a very bulwark in the war effort. The continuous strip mills built by the steel companies are now producing ship plates in unprecedented quantities and in tonnages which would have been impossible without these large investments. If the enormous amounts of debt which are incurred to build and establish steel plants are ever

to be liquidated, the funds necessary therefor must eventually come from earnings, and the earnings must be of sufficient amount in the aggregate to warrant the debt retirement.

Unless the tax rates are to be reduced by a sufficient amount to provide for debt retirement, we recommend that a portion of income equivalent to debt retirement be exempted from tax, or at least from the excess-profits tax.

The final point we desire to urge upon the committee is the establishment of a post-war credit.

We do not believe that the combined rates for normal and surtax and for excess-profits tax should be confiscatory. We fear that the rates as presently proposed are practically that. We strongly urge that if the combined normal and surtax rate shall ultimately be fixed at over 40 percent and the excess-profits-tax rate at over 80 percent, the law provide for a post-war credit of a percentage of income to be refunded to the taxpayer in Government bonds. Taxes at rates higher than those mentioned will prevent companies from laying aside any of their present earnings to tide them over the readjustment period which will inevitably follow the termination of the war. If some provision is not now made to enable the companies to secure funds for such purpose many companies will be forced into bankruptcy at great loss to the stockholders and loss of their jobs to thousands of employees.

To summarize then, gentlemen, we urge upon you first, that the invested capital credit be fixed at a flat 8-percent rate, rather than at the graduated rate set forth in the bill adopted by the House.

Second, that a portion of income equivalent to debt retirement be exempted from tax, or at least from excess-profits tax.

Third, that if a normal tax rate is fixed at more than 40 percent, and the excess-profits tax at more than 80 percent, that a post war credit of percentage of income to be refunded to the taxpayer in Government bonds be provided for.

Senator CONNALLY. To what do you attribute the fact that the Republic made $8,000,000 in a very short period and lost $20,000,000 just before that?

Mr. PATTON. I attribute it to several things, Senator. In the first place, in 1932, when it lost the $20,000,000, we were in the depths of the worst depression——

Senator CONNALLY. I thought you meant they lost $20,000,000 right lately.

Mr. PATTON. That was in 1932, in the midst of the depression.

Senator CONNALLY. We all lost then.

The CHAIRMAN. Even under this bill your average earnings can run as high as your 10-year average earnings prior to 1940?

Mr. PATTON. Republic came into existence in 1930, just at the beginning of the depression. It had to struggle to survive throughout the whole depression.

The CHAIRMAN. I understand that, but I say: Even under the bill, it is possible that you may earn more than you did during the average period from 1930 up until the defense program was commenced?

Mr. PATTON. It is possible, if you think that that is a fair average earnings to take in the case of a company such as ours.

The CHAIRMAN. I understand that, but I was making the inquiry because I recall a case presented here in 1941 at which time the tables of earnings were put into the record of this committee.

Mr. PATTON. That is correct, Senator. We asked for a 6-percent rate at that time, and now it is being reduced to 4.4 percent.

The CHAIRMAN. I understand that. Yes, sir. All right.

Senator BROWN. What rate of interest are you paying on that $95,000,000 debt?

Mr. PATTON. On the bulk of it we are paying 4½ percent, on a part of it 5½ percent, and on another part 2 percent.

Senator BROWN. What would you think of a proposal that in the case of a solvent going corporation such as yours, where this situation arises, as I can see it well may in your case, where you will be unable, with these higher rates, to meet both your Federal taxes and your debt commitments, to have the Reconstruction Finance Corporation take over that indebtedness and refer it over a longer period of time. Certainly at the rate of interest you state there, it would seem to me it would be a good investment for the Reconstruction Finance Corporation.

Mr. PATTON. You would put the Government in the banking business on a big scale if you took over all the funded debt of industry.

Senator BROWN. We gave them $5,000,000,000.

Mr. PATTON. We believe it would be better for the economy of the country if the company were allowed to keep enough cash to meet its funded-debt requirement each year.

Senator BROWN. That is decidedly unfair to the thrifty—I don't mean that the Republic has not been thrifty, but it is decidedly unfair to the taxpayer who is not in debt.

Mr. PATTON. We thoroughly appreciate that, and we believe that in justice to such taxpayer, when he pays his tax, he might be given, very appropriately, some Government bonds for some percentage of his tax to be used after the war.

Senator BROWN. That is Senator Taft's idea, and it is fair to everybody except the Treasury. Payment in bonds is a long way from payment in cash. The Treasury needs the cash. We had that problem before this committee in another way in 1939, and it related to the case of insolvent banks where the banking institutions were being charged an income tax, the reserves of those institutions, because they were getting income all the way along and bonds and other securities, and yet they were unable to pay their creditors, their depositors, a hundred cents on the dollar, so in this committee, as I recall it, and I think I do recall it accurately, we provided by amendment which was enacted, that the Federal Government would defer its tax collection until creditors had been paid a hundred cents on the dollar. After they were paid a hundred cents on the dollar, if the corporation or the reserve, the institution, had made sufficient money, they could go back and reassess that tax against them. I am quite sure that is existing law with respect to insolvent banks. Now, such an arrangement as that is not unfair to the Treasury, and it certainly is fairer to that class of taxpayers who aren't in the condition that you are or may be. It seems to me it is worthy of consideration.

Mr. PATTON. You appreciate the problem exists to raise the money and we, in industry, will appreciate a consideration of our problem however you finally determine to meet it.

The CHAIRMAN. All right, Mr. Patton.

Mr. Kelly.

STATEMENT OF WILLIAM J. KELLY, PRESIDENT, ARTHUR J. O'LEARY & SON CO., CHICAGO, ILL., AND PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE

The CHAIRMAN. Mr. Kelly, how much time will you desire?

Mr. KELLY. The statement that I had to present, Mr. Chairman, would take some 30 or 35 minutes to read, which I assumed was more time than you wished to give me, and so, with your permission I will abstract it for you and take not more than 10 minutes.

The CHAIRMAN. Yes, sir; that will be all right in the interest of time.

Mr. KELLY. I am William J. Kelly, president of Arthur J. O'Leary & Son Co., of Chicago, appearing as president of the Machinery and Allied Products Institute.

The Machinery and Allied Products Institute is a federation of trade associations. The member companies of these various trade associations are all capital-goods companies, and as the first paragraph of the formal statement says, these companies produce the Nation's facilities for production, transportation, communication, and commerce.

Now, in order to save time, Mr. Chairman, I will review the recommendations that we have made for your consideration in this more formal statement, and I hope that the committee at some time may have opportunity to refer back to our statement and review the arguments that we have presented to substantiate the recommendations that we are making. We think that there are grave dangers in very high excess-profits rates. We believe there are serious dangers inherent in these higher rates from the standpoint of their effect both on war production and on the ability of corporations to finance the post-war reconversion and reconstruction.

The impairment of war production arises from the effect of excessive tax rates on the economy and the efficiency of operations, and on the ability of corporations to finance the expansion of their war output. Such rates affect adversely the ability of corporations to sustain employment during the period of reconversion after the war and to make speedy and constructive adjustment to a peacetime economy.

This adverse effect results from the impairment of the financial liquidity of corporations because of an excessive drain on their cash position during the war. We, therefore, recommend:

First. That the maximum tax rate applicable to corporation profits during the war be not in excess of 80 percent.

Second, that if, in the judgment of the committee, a higher rate is necessary, taxes paid in excess of 80 percent be held as a post-war credit.

Third, that a post-war credit be made available generally to corporations up to a prescribed percentage of their wartime tax pay-

ments, whether these payments represent normal tax, surtax, or excess-profits tax.

Fourth, that this post-war credit be in the form of a special issue of Government bonds transferred to the taxpayer as his credit accrues, and that the proceeds of these bonds be available to the taxpayer after the war, either through sale or redemption, to be used for any purpose except the payment of dividends.

We think it very important, too, that the act is equitable in the determination of excess profits. We believe that the determination of excess profits under provisions of the pending bill is subject to serious inequities. In view of the very high excess-profits tax rates necessitated by the emergency, the elimination of such inequities becomes increasingly important. To this end, we recommend: First, that the normal tax and surtax be deductible before the excess-profits tax, thus restoring the order of deductions provided in the Revenue Act of 1940.

Second, that the average earnings credit be liberalized by allowing 100 percent of base-period earnings instead of 95 percent and by permitting the choice of the best 3 years of the 5-year period, 1935 to 1939, in the computation of base-period earnings.

Third, that the invested capital credit be continued at the 8 percent and 7 percent rates provided in the present act.

Fourth, that provision be made for the carry-back of unused excess-profits-tax credits against the excess profits of prior years as well as for a longer carry-over of such unused credits against the excess profits of succeeding years.

Fifth, that provision be made for the allowance of increased depreciation for tax purposes due to the abnormal intensity of use of productive facilities during the emergency.

Sixth, that provision be made for the deduction of reserves for post-war inventory in line with the recommendation of the Treasury.

Seventh, that the capital stock and declared value excess-profits tax be repealed.

That is the extent of our series of recommendations, Mr. Chairman, and, as I said before, the arguments that we wish the privilege of presenting to the committee for their study are listed in the formal statement that I will not take your time to read.

The CHAIRMAN. Thank you very much.

Are there any questions, gentlemen?

(No response.)

The CHAIRMAN. There seem to be no questions, Mr. Kelly.

Mr. KELLY. Thank you.

The CHAIRMAN. Thank you for your appearance.

(The following supplemental statement was submitted by Mr. Kelly:)

SUPPLEMENTAL STATEMENT OF WILLIAM J. KELLY, PRESIDENT, ARTHUR J. O'LEARY & SON CO., CHICAGO, ILL., SPEAKING AS PRESIDENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. Chairman and gentlemen of the committee, I wish first to express my appreciation of the privilege of presenting the views of the Machinery and Allied Products Institute on certain aspects of the pending tax bill. I say "certain aspects" advisedly, since I do not propose on this occasion to cover the bill comprehensively. This does not imply that the interest of the organization I represent is

limited to the particular features on which I shall comment. The contrary is the case. It means only that I prefer to concentrate on certain aspects of the bill which are of peculiar interest to the capital-goods manufacturers who compose our membership, and who produce the Nation's facilities for production, transportation, communication, and commerce.

The necessities of the emergency have led to a general concurrence of views on at least one principle of wartime taxation: The increase in tax burdens, both on individuals and on business enterprises, can stop only at the point where the unfavorable effects of additional taxes, from the standpoint of the national interest, exceed in importance the additional revenue derived. I assure you that this principle has the wholehearted acceptance of the industries I represent.

In considering the problem of the maximum tax rates on corporate profits desirable from a national standpoint, it is necessary to distinguish corporations which are unable, for one reason or another, to participate in war production, and whose taxable earnings are impaired by the emergency, from companies which have managed to fit into the program, and whose taxable earnings have been sustained or improved. As applied to the former, the problem of maximum tax rates concerns the normal tax and surtax; as applied to the latter, it concerns chiefly the excess-profits tax.

Because the manufacturers of capital goods whom I represent have generally found their place in war production, they are primarily concerned with the problem of excess-profits tax rates. If in the present discussion I concentrate on excess-profits taxes, it is not because we are uninterested in the fate of business enterprises, predominantly small companies, in danger of becoming casualties of the war because of their inability to participate in essential production, or in the impact of normal taxes and surtaxes upon such companies. We recognize the very great importance, from the standpoint of national economic policy, of preserving small business during the emergency and are gratified that both Congress and the administration are giving this problem their earnest attention. I pass over the question of normal tax and surtax rates chiefly because it is certain to be ably and eloquently presented to the committee by others.

In discussing excess-profits taxes, I have a two-fold purpose. First, I wish to indicate some of the dangers and disadvantages inherent in very high excess-profits tax rates. Second, I wish to emphasize the importance of an equitable determination of excess profits, and to point out certain deficiencies in the methods proposed in the pending bill.

I. DANGERS IN VERY HIGH EXCESS-PROFITS TAX RATES

The dangers inherent in very high excess-profits tax rates may be considered from the standpoint of the effect of such rates (1) on war production, and (2) on the ability of corporations to finance the post-war reconversion and reconstruction.

Effect of high rates on war production

The impairment of war production from excessive taxes on profits may arise both from a diminution of the economy and efficiency of production and from a lack of funds for financing the necessary expansion of operations. Let me discuss these effects in order.

Effect on economy and efficiency.—It is obvious that if a tax rate of 100 percent is applicable to any portion of the net income of a corporation there remains no financial reward for additional effort on the part of the company and no penalty for waste, extravagance, and inefficiency. So complete an extinction of incentive is generally recognized as unwise public policy. In the mass, producers will not put forth their maximum effort, or seek the maximum of efficiency and economy, in the total absence of financial compensation.

Let me quote a pertinent paragraph from a recent work by three British students of this problem.[1]

"Under a 100 percent excess-profits tax, once a firm is well past its standard revenue, it cannot only derive no financial advantage from well-planned business efforts, but also (what is more obviously serious) it can often avoid any financial loss even though its efforts are badly planned. The money which the businessman is administering becomes, so far as extra expenses and extra

[1] The Taxation of War Wealth, 1941, by J. R. Hicks, U. K. Hicks, and L. Rostas, pp. 45–46.

receipts are concerned, not his own but the Government's; he is suddenly converted into a civil servant, though he has not been trained as such; while instead of the detailed Treasury supervision usually considered necessary in the case of people who are administering public money, there is nothing but the ordinary provisions against income-tax evasion, to see that his money is not misused."

A similar conclusion was expressed recently by the staff of the Joint Committee on Internal Revenue Taxation in a report to the Ways and Means Committee of the House.

"In our statement to the committee the other day, we stated that it is impossible to tax the entire war profits from a practical standpoint. This is because, (1) some allowance must be made for the margin of error in determining income, (2) income is not always in the form of money or liquid assets, and (3) under a too high excess-profits tax, there would be no tendency to hold costs down to a reasonable basis. Demands for increased wages, advertising expenses, overmaintenance, and bonuses might result, and the Government and not the taxpayer will be the loser. By such methods, not only are resources wasted which are needed in war production, but the amount which the Government is required to pay for the facility or product is unnecessarily increased.

While there is general agreement that it is unwise to tax at a 100-percent rate any portion of corporate profit, there will always be differences of opinion as to the desirable upper limit of excess-profits tax rates. No strictly scientific test is possible. We believe, however, that the rate of 90 percent proposed in the bill is clearly too high. It leaves the taxpayer only $1 out of every $10 of excess profit, which we consider an inadequate incentive for efficiency and economy. We urge that the maximum rate be not over 80 percent, leaving the taxpayer at least $1 out of every $5.

As you know, a maximum rate of 80 percent has commended itself repeatedly to the judgment of legislative bodies under war conditions. This was the top rate applicable in this country, as well as in Great Britain and Canada, during the first World War. It is at present the maximum applicable in Britain, if we consider the post-war credit of 20 percent now in effect to be the equivalent of a deduction from the nominal rate of 100 percent, and will be the maximum in Canada under a similar arrangement proposed in the Budget now under consideration.

We concur heartily in the position taken recently by the Chairman of the War Production Board, Mr. Donald Nelson, in a letter to the House Ways and Means Committtee, that the tax rate applicable to the highest bracket of corporate income should not exceed 80 percent, but that if it does so the tax paid at rates in excess of this precentage should be held for refund to the taxpayer after the close of hostilities. Our preference for limiting the top rate definitely to 80 percent rather than placing it above that figure with a post-war credit for the amount of the excess is due partly to the fact that a prospective post-war refund is a less effective incentive to economy and efficiency now than a current tax abatement of like amount, but chiefly to the fact that funds paid out during the war at rates in excess of 80 percent, even though subject to refund at the close of hostilities, are not available to meet the needs of the taxpayer for the expansion of facilities and working capital during the emergency. In many cases the need for such funds is acute, as I shall indicate in a moment.

Effect upon the expansion of war production.—It is common knowledge that the emergency has made prodigious demands on war contractors for the expansion of facilities and output. Many of these contractors, as I know from contact with member companies in the capital goods field, have experienced, and are experiencing still, the greatest difficulty in financing the expansion of fixed and working capital incident to the increase in their production. They have had to rearrange and reequip their plants, and to construct additions, and have had to build up inventories of raw materials and work in process vastly in excess of any previously carried. They have experienced an additional drain of funds into the financing of an increased portfolio of receivables.

In many cases it has been possible to meet these demands only by heavy borrowing at banks, by securing advance payments on contracts, and by similar expedients. Even then the maintenance of an adequate cash position has been possible only because of an increase in liability for unpaid Federal taxes, resulting from the fact that income and excess-profits taxes are paid during the year

following the year in which they are accrued. This lag has provided a temporary source of expendible funds which will cease to be available when the payment of prior year Federal taxes equals the current rate of accrual.

We recognize, of course, that the impact of the war program on the financial position of corporations has varied widely, but we believe that the situation described is sufficiently prevalent, and sufficiently important, to confirm the conclusion reached in the preceding section of this discussion that the maximum tax rate applicable to corporate profits should in no case exceed 80 percent, and that a limit at this point is preferable, as a matter of national policy, to a higher limit accompanied by a provision for the post-war refund of tax payments at rates above 80 percent.

Effect of high rates on post-war readjustment

We are convinced of the preeminent importance of securing a strong cash position for American industry during the period of readjustment after the war. This is desirable not only for capital goods manufacturers, who hope thereby to increase the sale of their product during the readjustment period, thus stabilizing employment in a critical area that contributed much of the unemployment in the depression of the thirties, but also for the economy as a whole. Without a satisfactory degree of financial liquidity for business, the problem of sustaining employment during the period of reconversion, and of accelerating and shortening the reconversion process, will be greatly aggravated.

It requires little reflection to recognize that the cost of getting back into peacetime production after the war will be very great in innumerable cases. This is especially true where the corporation concerned is engaged during the war in manufacturing military material unrelated to its normal products. In such cases, it will be necessary, before income can be obtained from civilian production, to overhaul and retool machinery that can be converted, to purchase new machinery, to reorganize plant lay-outs, to retrain labor, and to acquire a new inventory of raw materials and goods in process. Frequently the evolution of technology during the war, the availability of new materials, and altered patterns of consumer demand will require extensive work in the designing and development of new products before production can be resumed. During this interval of transition and lack of income, contractual debt retirements must be met, current liabilities must be liquidated, and heavy payments must be made on Federal tax liabilities carried over from the preceding period of war prosperity.

Even where the corporation's contribution to the war effort has consisted in vastly expanded output of its normal peacetime product, as in the case of many machine-tool companies for example, the financial demands of the post-war period may nevertheless be very heavy. While the reconversion expenses will be minor compared with those of a company that has been making war products unrelated to its usual line, many companies of the type I am now discussing will find their post-war market relatively saturated because of the availability of a part at least of the enormous stocks of their products which have been built up during the period of war production, and which are offered in the market after the close of hostilities in competition with new units of the same type. Companies in this predicament must meet their debts, must maintain their organization, must carry the expanded facilities surviving the war, must attempt if possible to develop new lines for which a market is available, must pay off their carry-over of Federal tax liability accrued during the war, and must finance operating losses during the period of slack business.

I do not imply that these two cases by any means exhaust the variety of situations that will occur during the transition to a peacetime economy. They are sufficient, however, to indicate the nature of the problem. It seems quite evident that a very large number of companies, embracing a sizable if not a major portion of the industrial resources of the country, will find the post-war transition a tremendous drain on their cash resources.

It is true that many companies will be able to obtain a substantial amount of cash from the liquidation of the inventory of materials on hand and in process at the close of the war, and from the collection of accounts receivable. There are other cases, however, in which heavy inventory losses will be taken and in which the cash realization from the liquidation of wartime inventory will be problematical. Such funds as are obtainable from this source, and from the collection of receivables, will frequently be swallowed up in operating losses,

and will be unavailable for the renovation of facilities and the expansion of production into new fields. It is impossible to foresee precisely either the prevalence or the gravity of the difficulties of which I am speaking, but there is sufficient certainty of their general occurrence to warrant concern, and to justify the taking now of steps calculated to alleviate them.

One measure of alleviation I have already suggested—namely, the limitation of wartime excess-profits tax rates to a maximum of 80 percent. This will permit corporations to salvage one dollar of excess profits out of five for the purpose of strengthening their financial position and building up reserves for use during the post-war transition. The considerations just advanced lend added force to our request that if, in the judgment of the committee, it is necessary to recommend a maximum rate in excess of 80 percent, taxes paid above that percentage be refunded after the war to help in the financing of readjustment.

This measure of relief must be considered very modest indeed in the light of the probable need of corporations for funds after the war and should be regarded definitely as a minimum program. We believe that it would be a wise policy to go beyond this limit and to provide a post-war credit up to a prescribed percentage of all tax payments, whether for normal tax, surtax, or excess-profits tax. This broader program would make available a post-war reserve not only for companies reporting excess profits during the war, but also for less fortunate concerns. There is no reason to suppose that difficulties in financing the post-war transition will be limited to companies that were able to show excess profits during the war. It may even be desirable to make available a post-war credit for individuals as well as for corporations.

We feel strongly that a post-war credit, whatever the extent of its application, should be in the form of Government bonds transferred to the taxpayer as his credit accrues. These bonds might be non-interest-bearing and nontransferable until the end of hostilities, when they should become negotiable and should begin to accrue interest. The proceeds should be available to the taxpayer after the war, either through sale or redemption, in accordance with his requirements, and should be usable for any purpose except the payment of dividends.

II. EQUITABLE DETERMINATION OF EXCESS PROFITS

I come now to the second part of my discussion, which has to do with the measurement of excess profits for tax purposes.

If excess profits are to be taxed at the very high rates required by the emergency, it becomes increasingly important that they be accurately and equitably determined. I wish to indicate certain defects and inequities in the measurement of excess profits proposed in the pending bill, many of which are merely continuations of defects in the act now in force.

Reversal of deductions

The Revenue Act of 1940 provided for the deduction of normal tax and surtax before the computation of excess-profits net income. In the 1941 act, this order of deduction was reversed, making the excess-profits tax apply first and the normal tax and surtax afterward. The present bill proposes a third method by dividing the net income into two portions, one of which is subject to excess-profits tax alone, and the other which is subject only to normal tax and surtax.

This proposed formula represents a decided improvement over that of the 1941 act, since it avoids the application of normal tax and surtax to excess profits remaining after the application of the excess-profits tax. We believe, however, that the correct formula is the one embodied in the 1940 act and subsequently abandoned, and we urge its restoration by amendment of the pending bill.

In our view, what are sometimes loosely called profits before taxes are not in any proper sense profits at all. They represent merely an intermediate calculation in the derivation of true profits, which are the remainder available to the company after taxes are paid. We believe, therefore, that "excess" profits can properly be measured only after all taxes other than excess-profits taxes have first been deducted. We hold that as a matter of principle a corporation should be allowed free of excess-profits tax an income equal to its pre-war, or base-period profits after all base-period taxes, or, alternatively, an income, computed after all current-year taxes other than excess-profits taxes, equal to the prescribed rate of return on its invested capital. This principle can be satisfied only by a return to the 1940 basis.

Liberalization of credits

A provision of the present act, which the bill proposes to continue, allows only 95 percent of the base-period net income as an excess-profits tax credit. We have never discovered any rational justification for this limitation, and request that the credit be increased to 100 percent of base-period earnings.

While the amendments to section 722 proposed in the bill facilitate the correction of inequalities resulting from abnormal base-period net income, and are, therefore, to be highly commended, we believe the regular computation of base-period earnings should be modified to permit the taxpayer to elect his best 3 years of the 5-year period 1935–39, instead of requiring him to average the 4 years 1936–39 with no choice of years within the period. The change we propose will make possible a nearer approach to equity between capital-goods companies, whose earnings were abnormally depressed during a considerable part of the period 1936–39 and consumption-goods companies whose earnings showed, on the whole, a higher degree of stability and a more satisfactory level. The election of 3 years out of 5 would permit the former class of concerns to approximate more nearly to a fair standard of normal earnings.

The proposal to reduce the invested capital credit to 6 percent on capital of $10,000,000 to $200,000,000, and to 5 percent on capital in excess of $200,000,000, represents, we believe, an unjustifiable reduction in the credit available to large companies using the invested capital method. These rates of 6 and 5 percent are not only lower than the rate used in our excess-profits tax of the First World War (8 percent), but are below those allowed in present British and Canadian excess-profits taxes where circumstances require the computation of the credit on an invested-capital basis. We believe they are too low for a fair measure of excess profits, and urge that the 8 and 7 percent credits in the present law be continued.

Carry-back of losses and unused excess-profits tax credits

The institute I represent has repeatedly urged before committees of Congress the desirability and the justification of extending to 6 years the period during which losses and unused excess-profits tax credits can be carried forward against the income of subsequent years. I shall not dwell here on this recommendation, except to state that we continue to urge it as a measure of fundamental equity in the application of taxes to companies in industries, such as the capital goods industries, subject to wide and erratic fluctuations in earnings.

The unusual conditions now obtaining in the field of corporate taxation, and likely to obtain in the post-war period, justify the addition of a further recommendation; namely, that corporations be permitted to carry back losses and unused credits against the income of prior war years. As you are aware, this has been a provision of the British excess-profits tax since its inception. The privilege of carry-back assures that the taxpayer will pay on his excess profits for the war period as a whole, after offsetting against the excess profits of years showing such profits, the unused credits of other years within the period. This result is not only just to the taxpayer and to the Treasury; it secures equity between taxpayers whose earnings during the war period are stable and others whose earnings are subject to wide fluctuations.

Provision for accelerated depreciation

An equitable determination of excess profits does not depend alone upon a proper drawing of the line between such profits and normal profits. No formula, however accurate, can give a fair measurement of excess profits unless the taxable net income to which the formula is applied is itself properly determined.

A serious defect in recent revenue acts and in the proposed bill, which results in an overstatement of taxable net income, is the failure to provide a statutory authorization for the allowance of accelerated depreciation on productive facilities subject to abnormal intensity of use in war production. We refer particularly to facilities on which the normal depreciation rate allowed by the Treasury is predicated on one-shift operation, and which are now operating two shifts or more.

This intensification of use results in most cases in a shortening of the remaining life expectancy of the facilities involved, a result that should be recognized in the allowance of excess, or accelerated, depreciation. Such an allowance has proved exceedingly difficult to obtain from the Treasury under the

present regulations, which place an onerous if not impossible burden of proof upon the taxpayer. He must demonstrate conclusively his claim for increased depreciation, when in the nature of the case this claim turns on anticipations of the future which, however reasonable, may always be contested by skeptical tax officials.

We believe that taxable net income, and therefore excess profits, cannot be fairly determined under these stringent requirements, and we urge, therefore, that statutory provision be made for the allowance of accelerated depreciation on some reasonable and conservative basis that does not demand of the taxpayer conclusive demonstration of a matter that does not admit of absolute proof. We offer the tentative suggestion—and it is no more than that—that corporations be permitted to increase their depreciation deduction above normal by one-half the ratio by which machine hours, or other measures of intensity of use of facilities, exceed normal.

Provision for inventory reserves

Another factor which leads to an overstatement of taxable net income, and therefore of excess profits, is the inclusion in income of inventory appreciation due to rising commodity prices.

The paper profits resulting from such inventory appreciation do not represent cash available for the payment of taxes. They are impounded in the inventory, hence their taxation results necessarily in a drain on the cash position of the taxpayer. Moreover, such profits are certain in many cases to prove temporary, and will be offset by price declines after the close of hostilities. It is, therefore, exceedingly doubtful whether they should be included in income subject to war-time taxation.

The importance of this problem has been recognized by the Treasury, which has recommended a provision for inventory reserves in the following language:

"The Treasury therefore proposes that taxpayers be permitted to establish temporary reserves for possible future inventory losses, these reserves to be deductible in computing taxable income. The maximum amount to be added to the reserve in a year of rising prices, and hence to be deductible in computing income for that year, will be equal to the approximate amount by which price inflation has increased the value of the basic inventory during the year. Similarly, in a year of declining prices, the taxpayer would be required to subtract from his reserve, and hence to include in his income, the approximate amount by which price deflation has reduced the value of his basic inventory during the year."

We wish cordially to endorse this recommendation of the Treasury and to urge its favorable consideration by the committee.

Repeal of capital stock and declared-value excess-profits tax

I come now to the last point in my discussion, the so-called scissors tax. The continuance of this tax appears to have nothing to recommend it except that it provides a modest amount of revenue. I do not need to tell the committee that it does so at the cost of continuing annoyance to the taxpayer, and a good deal of additional labor in the preparation and auditing of tax statements.

That this levy produces a small revenue cannot support it once the principle is adopted which I have advocated in this discussion, that the regular excess-profits tax should be placed at the highest point justified by considerations of national policy. Whatever that point may be, there is obviously no excuse for superimposing a further levy not taken into account in its determination. We therefore respectfully recommend the abolition of the scissors tax, in line with the recommendation of the Treasury.

The CHAIRMAN. Mr. Farrar, do you wish to sit down or you may stand; just as you please.

STATEMENT OF W. W. FARRAR, PRESIDENT, COOK HEAT TREATING CORPORATION, LOS ANGELES, CALIF.

Mr. FARRAR. My name is W. W. Farrar. I am the president of Cook Heat Treating Corporation, of Los Angeles. Our business is the heat treating or the tempering of metals.

This is an appeal of a small progressive company asking your consideration of a change in the proposed amendment in the House revenue bill for 1942 in which taxpayers reporting on a fiscal-year basis will be required to report that portion of the 1941–42 fiscal-year income falling in 1942 under the 1942 Revenue Act. We refer to section 108 entitled "Taxable Period Embracing Years with Different Laws."

Our company does commercial heat treating and in 1939 saw the handwriting on the wall. We began to expand our facilities for the processing of defense and war materials. We have been sucessful in the processing of aircraft parts and at present approximately 98 percent of our production is for aircraft and tanks. In the past fiscal year our volume has increased approximately three times over the 1938–39 fiscal year. In order to handle this increase it has been necessary for us to apply all our retained income to the purchase of additional equipment, facilities, and working capital to process war goods.

At present we have made commitments for two large furnaces for the processing of aircraft tools for Wright Field.

Senator CONNALLY. Is the Government financing any of those improvements?

Mr. FARRAR. No, sir; not at all.

Senator CONNALLY. You are doing it all yourselves?

Mr. FARRAR. Yes, sir.

Senator CONNALLY. Your own company?

Mr. FARRAR. That is right.

Senator CONNALLY. All right.

Mr. FARRAR. These furnaces are shipped and should arrive at our plant by this week and they must be paid for some time in August. We are also erecting another 60-foot addition to our building to house furnaces for heat treating armor plate.

Our plant, we feel, is vital to war production. Day after day we get demands from our customers for increased production. As a result of our expenditures we are confronted with a serious financial problem.

We realize that both your committee and the House Ways and Means Committee have a tremendous job in writing a revenue bill. We have read the House Ways and Means Committee report relating to this proposed amendment. Our main point of appeal is based on the fact that we, as a fiscal-year company, after estimating taxes according to the 1941 act, have made commitments, which, with added impact of this new and unexpected additional tax burden, may seriously retard future increased production. It is further our belief—and we fully recognize the urgent need for revenue in the prosecuting of the war—that a taxpayer should be allowed to operate a full 12-month period under one tax law, so as to be able to reasonably plan the financing of its production at least that far ahead. In this particular instance the calendar year taxpayer was forewarned of substantially higher taxes to come, while fiscal year taxpayers have operated under the policy of applying current revenue bills to taxable years beginning after December 31 of the prior year, and were totally unprepared for this severe financial impact.

Our books were closed June 30, 1942, and our financial plans com-

pleted and commitments have been made after determining our tax liability under the Revenue Act of 1941.

We are doing our utmost to produce war goods and are not complaining of the tax burden, but we had no way to anticipate this additional burden under this proposed amendment. Consequently, with plans already effected, we are seriously overobligated without having provided for this additional outlay of cash. Therefore, we ask your earnest consideration of our proposal that the effective date of this amendment be changed to start with taxable years beginning after December 31, 1941.

We respectfully request favorable consideration be given this matter as we are one of many taxpayers who are in a similar position.

The CHAIRMAN. Any questions by the members of the committee?

Senator CONNALLY. When did you change your fiscal year?

Mr. FARRAR. 1937.

Senator CONNALLY. So, under that you didn't have to pay the higher taxes last year on a calendar basis?

Mr. FARRAR. No, sir.

Senator CONNALLY. No. With the expansion and all that, you will be able to make—with all these expansions that you are making, you will have a bigger output and make more money than you would if you kept it on the old basis, and thereby be better able to pay the taxes?

Mr. FARRAR. Our expenditures have been so great by the increased production.

Senator CONNALLY. Well, that is yours, not ours. It belongs to your company, the expansion. You got the benefit of it, didn't you?

Mr. FARRAR. Well, perhaps so.

Senator VANDENBERG. Is it of any use to you after the war?

Mr. FARRAR. No, sir.

Senator CONNALLY. How do you know?

Mr. FARRAR. Because our business is predicated on the oil-tool business. A commercial steel-treating business plant can only go so far. You can't expand indefinitely. When your customers have work that is sufficient or economical for them to put in their own plant, they do it, so the commercial shop keeps more or less on an even keel.

Today we are expanding largely and greatly because we have so much war materials dumped in our lap.

Senator BARKLEY. This advantage that you speak of because of the difference in the calendar year will only apply to this year. After this year it will level out?

Mr. FARRAR. That is right; yes, sir. After this year we will be in a position to know what is going to take place and to regulate our finances accordingly.

Senator TAFT. When rates are reduced you will pay the higher old rates for 6 months longer than the companies that are on the standard year.

Mr. FARRAR. Yes, sir; that is very correct.

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

Mr. FARRAR. Thank you, gentlemen.

The CHAIRMAN. Mr. Savoy.

STATEMENT OF PREW SAVOY, WASHINGTON, D. C., REPRESENTING THE DIRECTORS OF THE LINEN THREAD CO., INC.

Mr. SAVOY. My name is Prew Savoy. I represent the directors of the Linen Thread Co., Inc., a Delaware corporation, who are very large stockholders in the Linen Thread Co., Ltd., of Glasgow, Scotland, in connection with the change proposed in existing law by section 143 of H. R. 7378.

The Linen Thread Co., Ltd., owns 100 percent of the stock of an American subsidiary—the Linen Thread Co., Inc., and a substantial number of shares in another American thread company. It has maintained an office in New York City since 1937, where an employee of its subsidiary for many years looks after its investments. It does no other business in the United States.

Under existing law (sec. 231 of the Internal Revenue Code), and since 1936, if a foreign corporation is "engaged in trade or business," or "maintains an office or place of business" in the United States, it is required to file an income tax return in the same manner as a domestic corporation, and is then entitled to the deductions connected with its doing of business or its maintenance of an office.

If a foreign corporation meets neither of these requirements, then the taxes are withheld at the source and it files no return.

Since 1937 the Linen Thread Co., Ltd., has filed returns and has sought to pay the same tax as would a similarly circumstanced American corporation. The bill takes away this right.

It is proposed in section 143 of H. R. 7378 to make a single test for a resident foreign corporation, namely, the carrying on of trade or business. In other words, if a foreign corporation maintains an office to look after its securities and investments and is not engaged in trade or business, then it will not be considered a resident foreign corporation, and will not file an income-tax return and will not be entitled to any deductions, but a tax will be withheld at the source, as in the case of all other nonresident foreign corporations. If it engages in trade or business to any extent, then it will continue to file returns and take deductions.

This change certainly appears very illogical, when considered together with the change proposed in section 118 of the bill. It is proposed in section 118 to permit an individual to deduct the expenses paid or incurred for the production and collection of income, or for the management, conservation, or maintenance of his property. After these many years of income-tax law, for the first time it has been finally realized that a person may maintain an office to protect his securities and investments and not be engaged in trade or business, and that such an individual should be permitted to deduct the operating expenses in connection with that office. And I believe that this is entirely right. But that is exactly what Congress did in 1936 with respect to foreign corporations, many of which maintain and office purely to look after investments, when Congress enacted section 231 of the present law. If it is a fair and reasonable measure to adopt in the case of individuals, and I agree that it is, there hardly seems to be any logic in changing the law back with respect to foreign corporations which maintain such an office in the United States.

At the hearings before the Ways and Means Committee and the Senate Finance Committee, prior to the adoption of the 1936 act, it was clearly demonstrated that it was administratively impossible to collect the correct tax from all nonresident aliens who had income from American sources. This led to the adoption of a plan whereby foreigners not having a place of business or an office here were no longer required to file tax returns as they had been before 1936, and in lieu thereof, a uniform flat rate of withholding tax was imposed on all payments of income to nonresidents. This flat rate was calculated to bring in approximately the same aggregate tax that would have been obtained had it been possible to correctly administer tax returns as they apply to residents to all nonresidents.

Senator TAFT. I don't quite understand your case. You have got an American company operating in this country.

Mr. SAVOY. Yes, sir.

Senator TAFT. And the stock is all owned by a Scotch company?

Mr. SAVOY. That is right, sir. A hundred percent.

Senator TAFT. And the Scotch company has been making returns up to this time in this country?

Mr. SAVOY. That is correct, sir.

Senator TAFT. Making returns——

Mr. SAVOY. On the dividends and interest received from the American subsidiary.

Senator TAFT. How is it changed here? What happens after this goes into effect?

Mr. SAVOY. It maintains an office here, but does not engage in trade or business. This new bill limits these provisions to foreign corporations engaged in trade or business but if it has an office merely to look after its investments, it will not any longer file a return.

Senator TAFT. Then what happens? What is the result of that?

Mr. SAVOY. A withholding tax is paid which is six and a half times larger than a similar circumstanced American corporation would pay. If the parent company were an American corporation, it would have the 85 percent credit for dividends received from its subsidiary and would pay a tax at the normal rates and excess-profits tax.

Senator TAFT. The purpose of these amendments wasn't particularly to reach that kind of company, I don't think.

Mr. SAVOY. Yes, it was; definitely, sir. The recommendations made by Treasury were to the effect that companies having a nominal office were getting the benefit of such provisions that applied to American corporations and it was suggested that a single test should be made, that the single test should be "being engaged in trade or business."

Senator TAFT. If there were no Scotch company—the stockholders of the Scotch company are Scotchmen?

Mr. SAVOY. Some of them are, but there are very large holders who are Americans who hold very large blocks of stock, in excess of 100,000 shares. They are the persons in whom I am interested.

Senator TAFT. The American company, of course, pays its own tax on its own operation?

Mr. SAVOY. Yes, sir.

Senator TAFT. And the question is reaching the dividends that go to the Scotch company, to its stockholders?

Mr. SAVOY. That is correct.

Senator TAFT. If those stockholders were stockholders doing business in this country, they would be subject to the withholding tax?

Mr. SAVOY. Well, if the Scotch corporation were doing business——

Senator TAFT. If there were only one company doing business in this country, then all the dividends going to Scotchmen, and so forth, would be subject to the withholding tax?

Mr. SAVOY. That is correct.

Senator TAFT. The Treasury's purpose is to say that should be the same even though it goes through a Scotch company, I suppose?

Mr. SAVOY. No; I don't think it is that.

Senator TAFT. Or a foreign holding company, in effect?

Mr. SAVOY. They are not doing it with respect to one that engages in trade or business.

Now, there are some of our competitors that do probably a thousand or two thousand dollars worth of business and yet receive a million dollars in dividends. They will not be affected by this amendment.

Senator TAFT. Perhaps you had better get into business.

Mr. SAVOY. That may be so for the future. I think I needn't go any further to that point, if it is clear. I have another page or two of argument in connection with it, which is in the statement I ask leave to file.

The CHAIRMAN. Very well.

Mr. SAVOY. If the law is to be changed, however, we ask that it be prospective. When this bill becomes a law, the year will probably be over, the dividends will have been declared and paid, and our status will be changed retroactively, so we ask if you are going to make that change, you make it for the year after the current taxable year for the reason that our tax rate will be increased about six and a half times what it would be under existing law.

Finally again, if you conclude that you should make this change for tax or any other reason, we ask that you write your report in such a way as to show what the existing law is. There is considerable confusion resulting from what was done on the House side; there were no hearings and the recommendation made to the House by Treasury was to the effect that corporations had established a nominal office and were avoiding the treatment accorded other nonresident foreign corporations. They indicated that under existing law, you were correct if you had merely a nominal office to report income as a resident foreign corporation. Then in the House report, while suggesting that only one test be put into the statute, namely, being engaged in a trade or business, it was suggested that there was considerable uncertainty under existing law. This I consider to be a deliberate attempt to try to change the present law with respect to the years 1936 to 1941.

Now, there is considerable litigation pending in various stages in the Bureau of Internal Revenue and before the Board of Tax Appeals and before the courts, and we suggest that changing the rules with respect to existing law at this time, after foreign corporations have established their offices in good faith, is not the sort of thing which this committee or the Ways and Means Committee would permit when their attention has been called to it. No attention has been called

to the Ways and Means Committee, as this happened after all the hearings had been closed. Therefore, we ask that if the change is made, the report clearly show that a foreign corporation having an office or place of business to look after its investments while not engaged in trade or business under existing law is required to file a return and is entitled to deductions and credits but that this will not be permitted in the future.

Senator TAFT. Mr. Savoy, under the practice you have been following, what happens when the Scotch corporation made its return, took the dividends-paid credit, and paid a tax, then, if it took the dividends to Scotch stockholders, was there any deduction from those dividends?

Mr. SAVOY. No. We would not subject those dividends to any tax. Now, the dividends paid the American stockholders would be subject to tax.

Senator TAFT. Well, of course, American stockholders would pay those?

Mr. SAVOY. Yes, sir.

Senator TAFT. But I wondered: In other words, you get the advantage of the American law by getting the dividends-paid credit but then you don't have any deduction against the money that goes to Scotch stockholders?

Mr. SAVOY. That is right.

Senator TAFT. In that way, you are not like an American corporation.

Mr. SAVOY. Well, no. I am apparently confused in your question.

Senator TAFT. Well, I don't know anything about it.

Mr. SAVOY. The dividend of a million dollars is paid by the American subsidiary to the parent. Now, the parent files its return and takes a credit of 85 percent of that dividend.

Senator TAFT. Pays a tax on $150,000?

Mr. SAVOY. That is correct.

Senator TAFT. Then it pays a dividend itself?

Mr. SAVOY. Yes, sir.

Senator TAFT. To a Scotch stockholder in Scotland?

Mr. SAVOY. Yes, sir; and wherever else they are located.

Senator TAFT. There is no deduction from that?

Mr. SAVOY. That is right. Each stockholder pays his tax. American stockholders pay tax to the Federal Government. As in every other case, taxes are according to domicile and not source.

Senator TAFT. I see.

The CHAIRMAN. Any other questions by any members of the committee?

(No response.)

The CHAIRMAN. Thank you very much, Mr. Savoy.

(The following additional statement was submitted by Mr. Savoy:)

ADDITIONAL STATEMENT SUBMITTED BY PREW SAVOY, WASHINGTON, D. C., REPRESENTING THE DIRECTORS OF THE LINEN THREAD CO., INC.

The flat rate, referred to above, simplified the procedure of withholding agents as it did not require a determination of the taxable status of the recipient in order to know the amount of tax to be withheld. The Congress, however, clearly recognized that in some instances, especially foreign corporations having substantial investments in stock of subsidiaries in America, would

be vastly discriminated against and for that reason they adopted section 231 (b) of the 1936 act, providing that such taxpayers could, by establishing an office here and making themselves subject to the same requirements as a resident taxpayer, enjoy approximately the same tax status as the resident taxpayer. Surely, therefore, it is not the intention of this Congress to take a step backward with respect to the spirit of fairness which prevailed with the enactment of the 1936 Revenue Act.

The only argument that has been heretofore advanced so far as I know, to support changing the law, is that it is easier to reach an American individual than a foreign corporation. That would be the case, if the foreign corporation did not have an office and did not have sufficiently important investments in the United States to warrant an office. But when a corporation maintains an office and owns 100 percent of the stock of an important domestic corporation, to say that it cannot be reached as readily as an individual who can pick up and move out at will, is, to say the least, naive.

Secondly, if a change in law is to be made it is respectfully urged that the change should be for the future and not the current taxable year. The year will be nearly over when this bill becomes a law. As now written, it will penalize foreign corporations which have established offices, in reliance upon existing law, and have received dividends, declared and paid by domestic corporations, during the current taxable year. This seems to us rather harsh treatment of foreign corporations which have come in and submitted themselves to our tax laws.

Finally, the committee is requested, if it concludes that the right to file Federal income-tax returns should be limited only to foreign corporations engaged in trade or business, to write its report on the change in law in such a manner as to show the existing law.

In connection with the recommending to the Ways and Means Committee of the proposed limitation, the following was said:

"This provision has been abused, principally by foreign corporations which hold substantial amounts of stock in domestic corporations. By establishing a nominal 'office or place of business in the United States' they can avoid the treatment accorded foreign countries as described above and thus secure deductions and credits.

"This amendment would require that in order to get this treatment a foreign corporation or nonresident alien must actually be engaged in trade or business within the United States."

This language indicates that, under existing law, a corporation having an office to look after its investments is required to file a return and is entitled to the credits and deductions allowed domestic corporations.

However, in the committee report, at page 103, the following statement is made:

"A tendency has arisen, principally on the part of foreign corporations which are substantial holders of the stock of domestic corporations, and occasionally on the part of nonresident alien individuals, to attempt to establish that they have an 'office or place of business' within the United States and hence secure the very different tax treatment accorded taxpayers within class (b). Since such corporations and individuals engage in no other economic activities in the United States, they cannot be said to be engaged in trade or business within the United States.

"It appears to your committee to be in the interests of good administration to establish but one test (as is done with respect to capital-stock tax in sec. 1200) in ascertaining the classification of foreign entities; namely, whether or not it is engaged in trade or business within the United States. Such amendment narrows sharply the field of uncertainty arising in such cases and removes a possible avenue of tax avoidance to large foreign corporate and other holders of domestic securities."

This language of the report is intended to make legislative history which will affect prior years and pending cases.

In other words, the bill makes the single test—engaging in trade or business and yet the report suggests that such is now existing law—which is not correct.

There is litigation pending, due to regulations and rulings of the Bureau of Internal Revenue, which seek to limit existing law. It is believed that this language of the report is in furtherance of this objective.

Changing the rules respecting existing law at this late date, after foreign corporations have established their offices in good faith, is not the sort of prac-

tice which this committee or the Ways and Means Committee would permit when attention is called to it.

Had there been hearings on this amendment, we believe the Ways and Means Committee would not have so reported, if that committee had taken the action of this bill.

Therefore if this committee should agree to an amendment in substance similar to that contained in the proposed bill, it is respectfully requested that the committee state clearly that, under exsting law, a foreign corporation having an office or place of business to look after investments, while not engaged in trade or business, is required to file a return and is entitled to deductions and credits—but that this will not be permitted henceforth.

The CHAIRMAN. Mr. Hazelett.

STATEMENT OF C. WILLIAM HAZELETT, GREENWICH, CONN.

The CHAIRMAN. All right, sir. You may have a seat.

Give the reporter your name.

Mr. HAZELETT. My name is C. W. Hazelett, of Greenwich, Conn. I am appearing to present to you the relations of some findings of a subcommittee of this committee a few years ago on the subject of incentive taxation because it may have a profound bearing upon your financial problems, the question of whether you can get as much revenue as you want, the simplification of your present tax set-up, and an increase in production for our war purposes.

I think our tax policies are being all levied upon production as practically all but the excise taxes are, are reducing our production and have been doing so for a long time, that increasing the rates and increasing the number of people who pay taxes will tend, at any rate, to decrease production below what it otherwise would be so long as these taxes are levied on production.

Since we want a maximum of production, we should take some of the taxes off of that end of it and since we want to reduce consumption during the war period, more taxes should be placed on that end of the scale.

Now, I am going to talk to you about two things: First, how you can get far more revenue than your present bill proposes, without hurting anybody, either a corporation on an individual. I am going to show you how you can levy a sales tax in a simple way.

The CHAIRMAN. You mean you have got a painless system of taxation?

Mr. HAZELETT. I think so, and I have a great many other people who think so with me.

The CHAIRMAN. That is what we have been long waiting for.

Mr. HAZELETT. It will take me just a few minutes to go over this, if I may. The mechanism is in one page. I presume you have a copy of it before you.

After a brief study of incentive taxation in 1938 before a subcommittee of this committee, under the chairmanship of Senator Herring and a resolution of Senator Vandenberg, "Reasonable experimentation with incentive taxation" was recommended. The possibilities of this under present conditions are so astounding that I request the committee's study of the 1-page tax proposal which I have submitted, as a solution of practically all of your fiscal problems.

Now, the first proposal is not a revenue device. It is a device to stimulate production and to make the need for revenue much less.

This is rather new to those of you who were not on that committee, and who made no special study of the proposals.

If you will look at that with me for a moment, you will see that——

Senator CONNALLY. Just a moment. How would you determine the cash balance?

Mr. HAZELETT. Cash is all dollars under the control of the taxpayer wherever located.

Senator CONNALLY. Whether it is in his bank or in his pocket?

Mr. HAZELETT. Whether it is in his bank or in his pocket.

Senator CONNALLY. It would be hard to find it if it wasn't in the bank.

Mr. HAZELETT. There are a great many checks on this as you will see, particularly in the revenue phase, which is the next phase of this incentive taxation.

Senator BARKLEY. Why do you leave those spaces blank? Haven't you got any hypothetical figures you can put in there as an illustration?

Mr. HAZELETT. Yes. Which one?

Senator BARKLEY. The average cash balance. A, B, and C; all three.

Mr. HAZELETT. We ask both individuals and corporations to make a statement of their cash balance if it averages more than $500. The others are purely questions of fact of the corporations and individuals. They take their average cash balance on a monthly basis during the year and they divide that into their total real disbursements, as defined below, to get how rapidly they use their money in some productive way. That can be by expanding plant, by paying debts, dividends, taxes, insurance premiums, or benefits for charity or public welfare, or any payments that result in employment in the normal course of business.

Now, having determined how promptly a man uses his money in the purchase of Government bonds or in the production of munitions or in the payment of taxes, we have a device which compels the use of existing money to do what is now being done by new money being created by the Government. That is to say, private enterprise is compelled, under this system, to take their money and buy Government bonds promptly with it in these times, or go directly into the production of munitions, as they did in the last war, and if in case they spend it on themselves, in their living standards, that comes under the second or revenue phase of this tax proposal.

Now, passing just for a moment the question of the purchase of consumer goods and services. We note that when you have a tax on idle money which is what this amounts to, it compels everybody to promptly buy bonds with their wages, their salaries, their dividends, or any other kind of income, or to invest in armament production promptly or to pay their taxes promptly, say on a monthly basis or to pay them in advance, because they wouldn't build up tax reserves, they would be subject to tax because they were idle, they should be glad to pay their taxes ahead of time or as rapidly as they become obligated to them.

It would compel the quick distribution of the surpluses of corporations, something that we have done to a certain extent with the previous laws. It may, however, use this money to provide plant

expansion and get rid of the bottlenecks rather than paying it out in dividends at this time.

We would compel the hoarded billions in currency—and that represents some five or six or seven billions of dollars at the present time—and a great deal of idle bank deposits, to come out to purchase Government bonds or to produce munitions instead of the Treasury being required to borrow new money and create what most of us feel is substantially counterfeit money to finance this war.

You know that private enterprise has only furnished 20 percent of the plant investment in this war for armament purposes. In the last war they had provided 80 percent of it.

To sum up with this proposal, you can sell all the bonds you want at almost any interest rate you want on them, because with the tax on idle money they would buy the bonds rather than to pay the tax on idle money.

Senator CONNALLY. Let me ask this question: Your plan is essentially a sales tax?

Mr. HAZELETT. The revenue is a complete sales tax.

Senator CONNALLY. And you put it on employment. If a man hired somebody to work for him?

Mr. HAZELETT. No.

Senator CONNALLY. I thought you said employment here.

Mr. HAZELETT. That is the first phase which is not the revenue phase of incentive taxation. That is to compel the use of money to provide employment.

Senator CONNALLY. We want some revenue taxes.

Mr. HAZELETT. That is the next phase. I am pointing this out as a means of not needing so much revenue because private capital would take up the armament production, private capital would purchase more bonds, so that the current need for revenue would be decreased.

Senator CONNALLY. You have got a sales tax, though, on the purchase of Government bonds?

Mr. HAZELETT. Not at all. Anything but that. It is exempt entirely, if you purchase Government bonds.

Senator CONNALLY. Go ahead. I won't ask you any more questions.

Mr. HAZELETT. It is entirely exempt if you buy Government bonds.

Now, if you will notice this compels a corporation to continuously and promptly pay out its gross income to stockholders or to wage earners or to other employees or sources of supply. That is to say, all corporate income promptly becomes individual income in some form or another. This offers you a chance to gradually take the taxes off of corporations and put them on individuals and you need not lose 10 cents in revenue, because any dollar that is taken from the taxes in corporations comes out of some individual's income and can be taxed there, assuming we have a sound individual income.

Senator GUFFEY. This corporation doesn't save any money. It couldn't make any provision for a rainy day. How is it going to be in that situation?

Mr. HAZELETT. The rainy day is going to be when individuals do not purchase the products of corporations.

You will note this applies to all individuals as well as to corporations so that when the corporation pays out, let's say, its undistributed surplus to individuals, the individuals have then got to

promptly use that money either to buy the products of the corporations or to buy their securities.

Senator GUFFEY. Yes; but what is going to happen to the corporation when it goes in the red in its current operations?

Mr. HAZELETT. When the corporation goes into the red under current operations, it at least has the greatest opportunity to sell its product because the individual must either buy the products of the corporation so that it can make money or buy its original security issues.

Senator GUFFEY. But irrespective of whether it sells its products or not, it may go into the red, as some corporations go into the red when they are selling their products.

Mr. HAZELETT. They go into the red much more when they are not.

Senator GUFFEY. That may be true, but what is going to become of the corporation when it is going into the red if it has distributed all of its earnings?

Mr. HAZELETT. The same situation as at present. It goes bankrupt or in this case they have a tax on idle money and they have a chance to sell their securities.

Senator GUFFEY. You don't want to encourage corporations to go bankrupt?

Mr. HAZELETT. Not at all, sir. I want to encourage them to be successful. I want to offer them capital. I want to offer them customers all the time by compelling the man who has money either to purchase the products or to furnish the capital. You can't ask any more than that as an officer of the corporation.

Senator CONNALLY. There wouldn't be an incentive to save money under this.

Mr. HAZELETT. Yes.

Senator CONNALLY. You have got to spend it.

Mr. HAZELETT. Spend it or invest it, if you will notice. If you purchase Government bonds, for example, it is totally exempt. If you purchase original issues of corporate securities it is totally exempt. If you purchase existing issues, if you will notice on that, it reduces your cash balance, but will raise someone else's, the one you purchase the securities from, so that the net result from the revenue standpoint is balanced. You get the maximum revenue taxation.

Senator GUFFEY. What you are objecting to is merely keeping idle cash?

Mr. HAZELETT. Yes; idle cash means idle men.

Senator GUFFEY. I got the impression when you started that you wanted that distributed to stockholders. Now, you don't want it distributed to stockholders. You want it either distributed or invested?

Mr. HAZELETT. That is right. They can pay it out in dividends or the corporation can buy Government bonds and do it promptly with this process and thereby be exempt.

Now, the B phase of incentive taxation is a revenue tax, and if you will study it with me for a few moments I think you will see that it is possible to absorb gradually and practically every other form of taxation into that one form of taxation and not lose any revenue and get all the revenue that could possibly be collected by any tax.

If you will read the mechanism on that you will notice that I ask the individual to state his initial cash balance at the beginning of the

year, to add his gross income to it. Now, that is all the money he might spend on himself or his family. Then we deduct from that all money not used for his living standards. That is to say, all money not used for consumptive purposes.

I might say that this method of calculation is not original with me, but is one of Irving Fisher's recent developments, and I consider it vital to this particular proposal that we discussed before the committee.

Now, we deduct from this total cash available for spending a man's investments for profits, his business expenses, his interest, taxes, insurance premiums, contributions, medical care, and his final cash balance.

Now, these are all either at present deductible or they are things that do not appear in anybody's living standard.

Now, when you subtract two from one you have the entire living standards expenditures of the taxpayer.

Now, that is all of the sales that were made to him of all commodities, and all services at the same time.

Here this morning I heard Senator Brown and Senator Vandenberg point out the fact that a sales tax should include all services possible, as well as all goods, but here is a device which, by difference, includes all of them without any special calculations, without the infinite number of transactions to be recorded in sales taxes and without all the complexities of checking that.

I want to show you the immense advantages of that tax proposal and how it fits the businessman's needs and the individual's needs, and it is also politically acceptable.

Since under the tax on idle money, all corporate tax income proceeds promptly to individuals, there is no reason for losing any tax regardless of how much tax you might take off of production, that is, off of corporations. If you will notice also in that, we deduct from those spendings the personal exemption and his credit for dependents. That is taken away from his spendings—that is, all of the sales that were made to him. When you do that, you have a sales tax that includes everything, but is nonregressive.

You can give a man exemption at what I might call a destitution level, a bare living standard, and have a sales tax at the same time.

Having granted the taxpayer an exemption and credit for dependents on a subsistence level, it is possible for the Government to take every dollar a man has to spend on himself above that point.

The national income is now running around $115,000,000,000. The exemptions, as now proposed, represent something like $35,000,000. The Federal Government could take practically every dollar beyond that point if it had to do it for the war without causing any corporation to go out of business, because we could take the taxes off of them without causing destitution of a single individual, because you allow the exemptions. The widow's mite is protected by this personal exemption.

Senator CONNALLY. Is this plan in effect in any governmental unit?

Mr. HAZELETT. Not in its entirety at all. There are certain piecemeal forms of taxation that have been tried, and they all fail, such as the undistributed surplus tax, because they all give you something particular to do with your money, which is a restriction that you can't afford to put in your tax bill.

Even a policeman's fine grants you a credit for driving correctly, for example, and penalizes you for not doing so.

This would be a universal sales tax which you would collect with your income tax and not have to put a man to work in collection of a sales tax.

Now, the taxpayer levies every dollar of his own taxes after he has lived at a subsistence level; every time he spends a dollar on himself in either goods or services, he levies a certain amount of tax on himself.

Now, it is proposed that this tax be graduated so that the more a man spends on himself, the higher the tax rate. That is to say, it becomes a system of luxury taxation which defines a luxury as higher standard of living than a subsistence level, and you can graduate that to any degree you wish to and it is a method of carrying out the profit-sharing idea which was discussed under Senator Vandenberg's resolution, because, after all, there is only one real profit, and that is living standards. There is only one form of excess profits, and that is real and that is excess living standards, and we could tax them at an extremely high rate under this proposal.

Since the taxpayer levies his own taxes, no goose can squawk when he is plucking his own feathers. I can't conceive of a taxpayer complaining about a tax that he levies himself. I can't conceive of a man coming out publicly and saying, "I should pay less taxes when I live better than someone else."

Now, then, in wartime, by having these living standards tax rates, the spendings on the individual and family high, you can divert just as much of the national income to the war program as you desire, providing you have pressure on him to spend, lend, or invest his money in some other way.

It gets at the question of tax-exempt securities by not taxing the income from them whatever, not even questioning the source of income. We only propose that you should tax the spendings, whatever their source may be, so that revenue can be collected from any source, including all forms of securities.

Now, all excise taxes unless they are considered somewhat as fines, like the unusual consumption of alcohol, come out of people's living standards, all corporate taxes come out of people's living standards, and if you levied your taxes on the living standards, you can absorb all of those taxes in that particular field.

The same thing is true of social-security taxes. They come out of present living standards to provide future ones. Why not take them directly out of that?

Now, for the first time in income-tax history, we define income as what it really is. There is no economic income but the living standard of the taxpayer. No corporation enjoys any income but all individuals enjoy some form of income, and with these two proposals there isn't any question about ability to pay at any time.

If a man is foolish enough not to use his money, that is, let it lie idle, he has that money to pay taxes on it. There is no question about his ability to pay any fraction of his idle money in taxation.

We don't want revenue from that source. We want the money used. We want that tax to be zero.

If we grant an exemption to the individual which prevents destitution, the individual can pay any fraction of every dollar he receives

above the exemption. He could pay $999 out of $1,000, if the Government had to have it, and he would not starve or anything else like that happen to him. Nothing like that could happen, now, since this is a purely consumer, final consumer sales tax.

Senator CONNALLY. Let me ask you a question. I don't want to divert you, but you are about through?

Mr. HAZELETT. I am getting close to the middle of it.

Senator CONNALLY. Take women or widows who have a fixed income from savings or bonds or a foundation or something, how would this affect them? Would they pay on every dollar they spend?

Mr. HAZELETT. They would pay on every dollar they spend above the exemption. The exemption prevents any possibility of destitution because that is a living standard level as it is in the proposed tax bill. It is a very low living standard, I agree.

Senator CONNALLY. How much is it?

Mr. HAZELETT. Five hundred dollars, I believe is the final one in the tax bill on the individual, and $1,200 on a married person——

Senator CONNALLY. That is, the man's family is $500?

Mr. HAZELETT. Well, $400 for dependents is added onto that.

Senator CONNALLY. What is that?

Mr. HAZELETT. Four hundred dollars is added for dependents.

The CHAIRMAN. Have you anything else?

Mr. HAZELETT. Yes; I have a few more remarks.

It is anti-inflationary in its entirety, because all of the taxes are on the final consumer. It cannot be pyramided and it cannot be passed on to any other person.

The only thing you have to do to get more revenue time and you can get all there is by merely changing the tax rate instead of spending 6 months developing a new tax bill.

Now, then, since all of these living standard expenditures are what we are after in the question of inflation; that is, the cost of living is always the problem of inflation, all of these spendings of the individual are in his living standards—all of them are part of the cost of living, and we can restrain all of them.

I have added at the bottom of that page one item which states:

> The Federal living standard tax rate shall be uniformly raised from that required for revenue to absorb all increase in national income due to increase in the normal price level.

This is a device with which we can stop inflation, I believe, in two sentences. That is to say, if the price level went up 10 percent this year, national income goes up, let us say, $10,000,000,000 because of an increase in price level.

If you levied an additional $10,000,000,000, and I say that without hesitation, we simply take out of the system that money which does nothing to produce living standards, but which merely raises the price level and that maney can be used to pay off bank debt and prevent future inflation and stop the present one.

Now, we have at the present time the ridiculous spectacle of the O. P. A. doing everything as heroicially as they know how to stop the inflation of prices which is due to too much money in the system, and the Treasury is creating an average of a half billion dollars worth of new money per week, with nothing back of it, to more than offset

that. You could take half that money out of the present system entirely by taxation and pay off the entire bank debt and get rid of the entire burden and still have as much money as we had in the late twenties which was sufficient to provide maximum production and full employment of the entire Nation.

I would like to point out to you the fact—this may seem extraordinary—if you turn over the money at high rates, you could pay off Government debt, could sell no end of bonds at a tremendous rate with only a small amount of money taking part in the transactions, if you will consider that with me.

There is at least $5,000,000,000 in currency alone in the United States.

Senator CONNALLY. How many billions are there in all?

Mr. HAZELETT. About $12,000,000,000. There is conservatively $5,000,000,000 of extra currency which is not being used.

Senator CONNALLY. What do you mean by idle money?

Mr. HAZELETT. Money that is being hoarded.

Senator CONNALLY. In somebody's vaults? Somebody has still got that money?

Mr. HAZELETT. That is absolutely right, but supposing he holds onto it during the entire tax year. You have no employment, you have no revenue, you have no incomes to tax from it, you have no property values to tax.

The CHAIRMAN. I think we get your point.

Mr. HAZELETT. I am trying awfully hard to hurry here. I would like to state my primary interest in this.

You all know that when the smoke blows away there will be 25,000,000 people with nothing constructive to do. Senator Vandenberg made the statement that we could make a final successful assault on the depression and produce a cure with incentive taxation.

Senator CONNALLY. Does Senator Vandenberg approve of your plan?

Mr. HAZELETT. I don't want to say that he approves it in every detail, but I think we are in agreement in principle.

Judge Fletcher who testified here this morning made the statement that incentive taxation would put a half million people to work promptly in the heavy goods industries at the time of those hearings.

When the smoke blows away you will have 25,000,000 people with nothing immediately constructive to do. You don't have to do a single thing to solve the unemployment problem at that time but to keep the money which is now turning over to employ soldiers, to produce munitions, to reconvert our plants to peacetime products, or to buy those products. You have nothing to do but keep a tax on that idle money, and you won't have any unemployment when the smoke blows away.

The CHAIRMAN. Anything further?

Mr. HAZELETT. I would like to say just one thing: That if you want more revenue here is a chance to get twice as much revenue, in my opinion and in the opinion of the people who know me, though harming the taxpayer or corporations or individuals.

If you want to stop inflation, I see a tax on the living standards expenditures of the individual as a simple device to do the whole thing. If you want full employment when the smoke blows away rather than the most devastating situation that our country has ever

faced, I suggest you give serious consideration to the taxing of idle money so it will compel that money to employ those people immediately when peace is declared.

Senator BARKLEY. How much money would it raise?

Mr. HAZELETT. I have discussed it with Lovell Parker, who was the chairman of the joint committee for many years on this. He says that in his opinion there would be no difficulty in raising $40,000,000,000 with a tax of this kind.

Senator TAFT. How would you get $40,000,000,000 worth of taxes?

Mr. HAZELETT. The national income is $115,000,000,000 at the present time.

Senator TAFT. The estimate is there is not going to be but 50 or 60 billion dollars worth of consumer goods that anybody can buy.

Mr. HAZELETT. That is right. If you have 50 or 60 billion dollars worth of consumer goods you subtract 60 from 115 and you will have $55,000,000,000 that could be collected and might just as well be collected in taxes, because it is of no benefit to anybody.

Senator TAFT. You mean collect a hundred percent over what anybody has after they have spent——

Mr. HAZELETT. They have no use for it. They can't buy anything with it. It is just a question of bookkeeping corresponding with the facts. It is just like handing out new money as if there was something to buy with it.

Senator TAFT. It is a little unfair to the fellow who has increased his income and isn't able to increase his standard of living.

Mr. HAZELETT. Anything but that. That is true at the present time of the present income tax and more so, I should say, than this would be, because if you, by better management and more production at the present time, earn a greater income, you could by buying Government bonds with that income, have a greater exemption from taxes than at the present time.

Senator TAFT. Than at the present time?

Mr. HAZELETT. Than at the present time, yes; or under the proposed bill, by all odds, because if I lived at a subsistence level and I put all my money into Government bonds, which is what the Government wants me to do, I would be exempt from all taxes.

Senator CONNALLY. May I ask what business you are in?

Mr. HAZELETT. I have been a consulting engineer and a development engineer all my life. About 3 years ago, because of ill health and a few other things, the fact that I am in a business of high risk, I have retired. I have been operating my farm and doing a little writing, and I am going to give the next year to this particular thing if I can.

Senator BROWN. You have written a book on this subject?

Mr. HAZELETT. Yes; there is a book on the subject.

Senator BROWN. What is the title of it?

Mr. HAZELETT. "Incentive taxation." I shall be glad to see that you get a copy of it.

Senator BROWN. Thank you.

(Mr. Hazelett's prepared statement is as follows:)

STATEMENT SUBMITTED BY C. WILLIAM HAZELETT, GREENWICH, CONN.

I shall not mention your problems. You know them. I shall discuss the answers. You have a 820-page and the most-complicated and controversial tax bill in history. It will bring no fraction of the revenue really required. It will

penalize and therefore restrict production which will determine the outcome of the war. Many hardship provisions must be added to further complicate it. I feel sure that you will consider a 1-page tax bill which can bring all the revenue that can be collected, which will stimulate instead of restrict production and which will be acceptable to your constituents as entirely just.

After a brief study of incentive taxation in 1938 before a subcommittee of this committee, under the chairmanship of Senator Herring and a resolution of Senator Vandenberg "reasonable experimentation with incentive taxation" was recommended. The possibilities of this under present conditions are so astounding that I request the committee's study of the 1-page tax proposal which I have submitted, as a solution of practically all of your fiscal problems.

The first proposal is not a revenue device, but one which results in the maximum revenue to collect, and other Government financing. It is a tax device to compel the prompt use of money in the purchase of Government bonds, the production of munitions, the prompt payment of taxes, etc. The second is an all-out sales tax without the regressive and complicated features of the ordinary sales tax, and a form of tax which can absorb every other form of taxation except of the windfall type.

Referring to the nonrevenue "A" tax on the sheet before you, we determine the promptness of money used by the following mechanism.

A. NONREVENUE INCENTIVE TAX

All individuals and corporations having average cash balances in excess of $300 shall pay 2 percent of said balance for each turn-over less than 8. (If turn-over exceeds 8 this tax is 0.)

Turn-over calculation

(*a*) Average cash balance (monthly) during year_____ _____
(*b*) Total real disbursements during year_____ _____
(*c*) Turn-over rate (*b*) divided by (*a*)_____ _____

Definitions

Cash is all United States money under control of the taxpayer on the first of each month, wherever located.

Real disbursements are all expenditures for the purchase of original issues of stocks, bonds (including governments), mortgages, the payment of taxes, dividends, debts, insurance premiums or benefits, for charity or the public welfare, for employment, for the purchase of any goods moving directly to consumption or any other payments on a direct course to provide employment.

Passing for the moment the purchase of consumer goods and services which I shall discuss later, we note that this simple device offers a most powerful incentive at all times to everyone to immediately buy bonds with their wages, salaries, dividends, rents, royalties, or any other form of income, or to invest their income promptly in armament producing enterprises, or to pay taxes promptly, more frequently or even in advance to escape this tax. It will compel quick distribution of surpluses either in wages or dividends or immediate plant expansion. It would bring out the hoarded billions in currency and the billions of idle or slow-moving bank deposits to finance the war, instead of the Government being obliged to create billions in new money to replace this idle capital. In this war, private financing for production is only 20 percent of the total. In the last war it was 80 percent. Obviously if private money of either individuals or corporations is invested to produce armament or to buy bonds, the Government requires less in current taxes.

To sum up; by this, the A phase of incentive taxation we could sell bonds without effort, compel private money into war production, stop Government borrowing from the banks, impel the payment of taxes frequently and as promptly as desired, plus far more important benefits to be discussed later. This is a conscription of money to back our conscripted men.

Since the idle money tax continually pushes a corporation's gross income, which includes its net income, its capital gains, its surplus and its excess profits into the pay of the employees, dividends of stockholders, taxes, or Government bonds; all except the latter two items promptly become individual cash income. (For those who fear the corporations financial stability, please

note that the employees and stockholders must also promptly and continually use their money to purchase the products of the corporations or buy their securities, thus promptly returning the money to the corporation, something the undistributed profits tax failed to require.)

With a sound individual tax we can proceed in time to the total absorption of corporate taxes at this point. Since a corporation enjoys no income, time shows that there is no sound corporate income tax and the endless attempts to make them just and workable attests this fact. Individuals do enjoy real income in their living standards and there can be no more and no less economic income than the living standards of the individual. Since all corporate income would become individual cash income we would not lose any revenue whatever if the tax is properly levied and our corporation executives could go back to their real task of producing planes, tanks, and ships.

The B phase of incentive taxation proposes such an individual tax, and was also a subject of study by the subcommittee. It is similar in principle to the spendings tax proposed by Ogden Mills. It has been substantially improved by a checking device recently developed by Prof. Irving Fisher and the novel part of a book by him, now on the press.

Referring to:

B. REVENUE PHASE OF INCENTIVE TAXATION

Income for individual tax purposes is defined as all money expended by the taxpayer for his living standards and is determined by difference as follows:

1. Add all cash receipts to initial cash balance. (The maximum possible living-standard expenditures.)

2. Deduct from 1 all money not used for the comfort or the enjoyment of the taxpayer and his family, which includes all money actually paid out for investments for profit, business expenses, interest, taxes, insurance premiums, contributions, and medical care and taxpayer's final cash balance.

3. The remainder will represent taxpayer's entire living-standard expenditures for the period; his spendings income.

4. From 3 subtract personal exemption, credits for dependents, and earned income credit as at present, giving 4 the taxable income.

5. *Calculation of tax.*—Rate for first $1,000, _____ percent, increasing at the rate of ____ percent for each additional $1,000.

This simple form of taxation has the following extraordinary advantages:

As before mentioned, since all corporate cash income proceeds to individuals it can all be subject to tax on the individual.

Having granted the taxpayer an exemption and credit for dependents on a subsistence level, it is possible for Government in war to take any fraction of every dollar the individual may have to spend without producing destitution. The maximum possible revenue may be collected.

This tax is an all-inclusive sales tax which includes not only all purchases of commodities but all services as well, such as domestic services, travel, etc.

It would be a universal sales tax collected by the existing income-tax machinery instead of a levy on hundreds of millions of transactions to be recorded and checked.

The taxpayer levies every dollar of his own taxes. No man can fairly complain of paying more than another if he lives better. No goose can conveniently squawk when plucking his own feathers.

By graduating the rates steeply in wartimes, we have to any desired degree a luxury tax. The higher the living standard, the higher the degree of luxury and the higher the tax rate.

By having all rates high we ration and control spending in wartime, and can divert as much of the national income to armament as we like, we compel the public to cut down expenditures to the bone as Sir Kingsley Wood insists must be done.

We tax the only true excess profits, i. e., excess living standards at as high a rate as desired.

We solve the question of tax-exempt securities by not taxing the income therefrom but only taxing spendings, whatever the source.

All excise taxes, unless considered as fines, are automatically in living-standard expenditures and could be eventually absorbed therein.

All social-security taxes come out of present living standards to provide future ones and should be absorbed in the same manner.

High consumption taxes would cause self-denial in war and the purchase of Government issues at even nominal interest rather than the payment of an excessive consumption tax.

For the first time in income-tax history there would be no question about ability to pay either the A or B tax. If a man has $10,000 of idle money, there is no question about his having the money to pay any fraction of that in taxation. If we grant an exemption preventing destitution, anyone who has $1,000 to spend on himself above that amount can pay anything up to $999 in taxes for the privilege of spending the other dollar.

Like all consumer sales taxes, it cannot be passed to others and does not pyramid and result in price inflation.

The living expenditure tax is anti-inflationary in proportion to its rates, since it can siphon off any amount of purchasing power desired.

It only taxes capital gains if used in the taxpayer's living standard, wiping out the at times unjust and highly repressive nature of this tax.

It eliminates the necessity of calculating business income with all the problems of depreciation, etc., merely taxing cash income from business when spent on living standards.

In short, it is a tax which can absorb all other taxes except inheritance taxes and one which meets the basic requirements of any sound tax—ability to pay, simplicity, and justice.

Up to this point and because of the question of constitutionality I have not mentioned the only incentive tax item required to make the living expenditure tax a complete living standards tax. The latter has far-reaching possibilities in addition to those above mentioned, and requires a slight modification by adding the real income to the taxpayer resulting from the use of property owned by him and not used for business purposes. Heretofore this is only subject to local taxation.

If income in the XVI amendment were construed to mean the taxpayer's living standard, the only real income possible, we should make the following additions to the B incentive tax and as originally proposed.

To 1 add rental value of taxpayer's property not used for business purposes.

In 2 include as a deduction principal and interest payments on above property. (Payments not constituting living standards.)

Our revenue base would now include for practical purposes all items contributing to living standards and we would have a single and all-comprehensive real income tax base for city, county, State, and Federal taxation. Each of the taxing jurisdictions could levy its own rate on this base and the entire tax could be collected by one authority such as the State, and disbursed to the local and Federal authorities in proportion to their levy.

With such a system af taxation we require only to change the rate to vary the revenue. Federal taxation of property is justified since defense and many other services protects property, just as local government is justified in taxing living standards which it protects, for example in food supply.

With such a simple mechanism we can solve our revenue problems, eliminate practically all other forms of taxation, resolve the question of Federal versus local taxation with such simplicity and justice as to command rather than destroy the loyalty of the taxpayer.

Control of inflation

Since our living standard base includes all consumer prices, rents, etc., we can regulate the general price level by merely varying the rates. We must first select the most suitable cost of living as our normal price level, then add to "B."

The Federal living standard tax rate shall be uniformly raised, from that required for revenue, to absorb all increase in national income, due to increase in the normal price level.—In other words if the price level increases 1 percent in a month and national income has increased 1 percent in the same period, we absorb the entire 1 percent increase in income by raising the rate the required amount. The result is to take all surplus purchasing power out of the system which causes price rises. This money received in taxes should be used to retire bank debt, the principal cause of inflation, and thus get rid of the legal counterfeit which has been "primed" into the system. This will stop present and prevent future inflation.

We merely need to circulate the remaining money as rapidly as we did in prosperous times to provide full production at the selected price level.

We now have the ridiculous spectacle of the Treasury creating billions of new dollars by bank borrowing, which everyone knows is inflationary and another Government organization, the Office of Price Administration trying heroically to stop it.

Government war debt is merely the price the people charge the people for protecting the people, and rising prices simply means that the people are charging the people more money.

It is now worth while to consider how high turn-over rates of money help solve all sorts of monetary problems, including Government financing by either the sale of bonds or by taxation, the payment of debt and finally the most important the problem of full employment after the war.

We have at the moment some five billions in idle money in the form of hoarded currency, and in addition, many billions of idle or very slow moving bank deposits. Let us assume that, to escape the idle money tax, five billions of this total are used this week to buy war bonds at a very low interest rate. Assume also that Government now pays this money for armament back to the public, the following week. The public now has as much money as at first and it is no hardship whatever for it to promptly but another five billions in bonds with this same money since it was not being used and because it would be again subject to tax if not used. If we could repeat this cycle say every 18 days we could sell $100,000,000,000 worth of bonds in 1 year, pay for one hundred billions in armament and at the end of the year the public would have just as much money as at the begining and only five billions in money which had been idle would be used in the entire transaction, and the interest rate could be nominal.

Let us assume that, instead of borrowing from the public, we levy an extra five billion in taxes next week. By compelling the idle money to be used it would be available to pay taxes, immediately. The Government now pays out the five billions promptly as before and the public has once again the same amount of money as before taxes. Repeating this cycle every 18 days we could levy one hundred billions in extra taxes and can immediately pay another five billion and only use five billions of now useless money in the entire transaction. We could balance the budget anytime by such a policy, stop bank borrowing, get rid of the interest burden and avoid ultimate repudiation of our debts.

In paying off Government debt already incurred, the same conditions apply. After the war we can continue to levy the one hundred billions in extra taxes by the repeated use of five billions in surplus money. There is no question of ability to pay, whatever, and we could retire the debt at a tremendous rate. The turnover rates I have suggested are obviously high but they could be achieved.

Thus the whole problem of Government finance depends upon the rapid turnover of money.

When paying off Government debt, the living standard tax is vital as a matter of just distribution of the burden. The person who would receive large amounts of cash by the redemption of his bonds must promptly use this money to employ men, bringing up their living standards. If it is used for his personal living standard on a large scale, he is heavily taxed. If he invests it to raise the living standards of others, these latter pay the tax. We thus maintain employment and at the same time distribute the tax burden on those who receive the benefits in their living standards.

The value of defense to anyone is the protection Government gives to a man's life and how well he lives and that such protection is in no way related to his holdings of business property, securities which raise the living standards of others.

When Government debt is retired for reasons I shall not mention now, graduated taxes should be abandoned.

We must note that no one can escape taxation except by living on a subsistence level and putting his money to work to raise the living standards of others. During war he may escape by buying Government bonds or in investing in armament production by private enterprise which in either case, reduces the Government's need for current taxes.

Every use of his money thus results either in revenue or decreases the need for taxes, but no dollar that is idle produces any living standards, any revenue or any guns.

Having discussed the effect of incentive taxation on war financing, debt payment and inflation control; all of these problems and solutions fade into utter insignificance when compared with the question of "How can we promptly put twenty-five or thirty million people into peacetime production, when the smoke blows away?"

No assumption but victory is tenable. To achieve that we must have the greatest aggregation of armament in history and to secure peace we must take most of the war equipment of the vanquished. We shall then have no need for further armament for years to come and with peace on the battlefields we shall have peace in the factories.

Many believe that pent-up demand produces employment. What are the facts? For 10 years we continued to build up more and more pent-up demand, during the depression, and it never produced any employment. Poverty does not create prosperity.

We have so far instituted no successful device except war to provide employment. Many propose that Government shall put our people to work. It could not put 25,000,000 people to work without taking over the tools of private enterprise, for they would have nothing to work with. To do so is, of course, to adopt totalitarianism, which is what our people are working, sacrificing and dying to destroy. I need not tell you that 25,000,000 people of whom millions know how to shoot, will neither go on bread lines nor will they come to Washington to talk.

What is the answer? We now have and will have far more money in the hands of private enterprise than we had at our period of maximum employment and prosperity. Therefore unemployment will not be due to lack of money but only to lack of prompt use of it.

Let us see how high money turn-over rates solves unemployment. Assume I have $5. I use it today to employ A. A uses it tomorrow to employ B. B uses it the next day to employ C, etc., for say 300 turn-overs per annum. We would produce $1,500 worth of employment in a year with $5. Assume again that I employ A tomorrow with it. A holds it an extra day before employing B. B holds it an extra day before employing C, etc. We would then only have 150 turn-overs per annum and only $750 in wages paid and these men would be out of work half of the time. Assume on the other hand that I hold the money idle for the year; there is no employment whatever and if A, B, or C hold it, it stops all subsequent employment. We see that for any of us to hold money in idleness, longer than we do when we have full employment, we have employment in direct proportion to the decreased turn-over rate of cash.

Since we have plenty of money, we only need to apply incentive taxation to A, B, and C and everyone else, having any substantial quantity of money, to spend or invest it promptly in ways which result in employment, to solve this great problem. The money now turning over rapidly in the production of war material need only continue to turn over rapidly to produce the only thing there will be a market for, namely, peacetime goods. Whoever has the money must, in order to escape the idle money tax, promptly and continuously furnish the capital to produce goods or buy them.

Let us permit the people to plan the future. Let us permit them to select their own servants, those from whom they buy both goods and services, instead of the Government planning what they shall produce which is what they can buy.

Let us permit the people to select their own masters. If they do not like to work for one man, the latter must find someone else to use his money to employ them. Thus they would select their own servants and their own masters, the foundation of freedom. Let us permit the citizen to levy his own taxes, which in that sense makes "every man a king." Let us stimulate and even compel private enterprise, the essence of democracy, the dynamic system which built the greatest nation on earth to plan and build our future by compelling it to continuously provide full employment by incentive taxation.

It was unemployment that produced Hitler. It was unemployment which weakened and disunited France, Britain, and the United States. Let us prevent the greatest of all disasters; civil war, which will come from great unemployment after this war. Let us show the rest of the world that we are fit to lead by solving our own problems. Let us offer our people a definite future worth

fighting for and tell them not what we are going to do, but how we are going to do it. None of them can understand the proposed tax bill. All of them want a simple, a just tax bill. All of them want everyone else to promptly furnish them capital or buy goods or services.

If we really want revenue with simplicity and justice, if we wish to take the restrictions off of production and place them on consumption where they belong, I recommend for your consideration a "mercy-killing" of the proposed tax bill and the adoption of the principles of incentive taxation.

The CHAIRMAN. Mr. Priestley.

STATEMENT OF T. J. PRIESTLEY, JR., PHILADELPHIA, PA., PRESIDENT, PRIESTLEY PRINTERS

The CHAIRMAN. You may proceed.

Mr. PRIESTLEY. My name is T. J. Priestley, Jr. I am the president of the Priestley Printers. I own the Priestley Engineering Co. I am a charter member of the National Small Business Men's Association. I mention that fact only because I am interested in their program.

Mr. Chairman, I am here to advocate a Federal gross sales tax which I believe is the instrument needed to raise most equitably the extra amount of taxes called for by the Treasury. I am opposed to the general sales tax because it imposes an extra burden on those least able to pay. I have been before your honorable committee several times since 1935, but have failed to make my plan comprehensible. I have arranged my statement in the form of questions and answers.

Senator BROWN. Do you think that is your fault or the committee's?

Mr. PRIESTLEY. I am not saying. I have tried hard.

What is the graduated gross sales tax?

It is a fractional tax on gross sales, or profit transactions in each different line of enterprise.

Is it a multiple tax?

No; it is a single tax, which would eliminate most of the other taxes, excepting the personal income tax and a few excise taxes such as on liquor, cigarettes, and so forth. The Federal Government would return to each State a proper percentage of that collected from each State.

Why is it called a graduated tax?

Because the tax is graduated in what may be called fair amounts in each enterprise.

What is a fair amount?

A fair amount is a fraction of the total amount of business done by all enterprises in a similar line.

How is this fraction determined to establish the fair amount in each line?

The total amount of sales in each line of business will be divided by the number of corporations or individuals following a certain line; this would give the fair amount for the purpose of taxation.

What would the tax rate be on all businessess?

I would suggest a one-fourth of 1 percent gross tax, increasing in arithmetical progression by one-fourth of 1 percent for each fair amount. This base rate would produce approximately $12,000,000,000, of which $6,000,000,000 should be returned to the States.

Would this tax be in reality a pyramiding tax?

Yes; rightfully so. We have tried to frustrate monopolies, not because they produce things which sell for less, but because they hinder many citizens' production of a fair share of the Nation's abundance, which is his natural right as well as his constitutional guarantee to pursue happiness in attaining his livelihood.

Monopolies are like big snowballs consolidating with other big corporations in the same line while rolling and crushing smaller concerns. This policy of consolidating and monopolizing is forced on big business and is the logical outcome of our Government's inefficiency in controlling or stabilizing our national economy.

A Federal graduated gross sales tax will facilitate this economy.

As if the consolidation in each particular line of business was not burdensome enough on small business and their millions of would-be employees, these monopolies are forced to purchase their supplies from other monopolies fathered by the same central agent.

They are a government unto themselves. While our Government calls them "Princes of Privilege," "Economic Royalists," and so forth, and raps small business, saying that "the Nation has no obligation to make America safe for the incompetent businessmen who fail to note the trend of the times," still our Government has given no logical thought for curing the Nation's chaotic state. We cannot reduce the sway of the so-called "Economic Royalists" and the "Princes of Privilege" by collective bargaining or other abuses or by abetting sit-down, slow-down, or hammer-down strikes.

In despair we exclaim "A plague on both your houses," when, as a matter of fact, we are in the worst racketeering plague that ever beset a democratic people, yet we hope to win the war on a foreign soil.

Our Nation has become so weak from hate, economic insecurity, and disunity that the Japs think they can beat us and are even now gnawing at our vitals.

Let us not increase the Nation's discontent by imposing on our people a general sales tax when the actual needs may be met by a graduated gross tax.

How would you proceed to levy the graduated sales tax?

The United States Census Bureau has all the facts appertaining to the number of businesses following each line and the volume of sales transacted by each corporation. The returns from the tax will give the fair amounts for each succeeding year. The fair amounts and the base amount will increase or decrease each year according to the prosperity of the Nation.

Will this tax reduce inflation?

It will not increase or decrease inflation at this time, but it will gradually tend to stabilize both wages and prices at their fair values, by making it possible for small business to exist and pay wages comparable to that paid by the larger corporations, or make it impossible for the large corporation to pay wages out of proportion to that paid by small business.

Inflation, should it occur, will accrue to the benefit of the Government.

Mr. Chairman, may I have these galley proofs distributed in order to show the workings of this tax?

The CHAIRMAN. Yes.

Mr. PRIESTLEY. It will take me just a minute.

Senator CONNALLY. Mr. Chairman, I have to leave the committee in about 15 minutes.

The CHAIRMAN. We have two other witnesses, Mr. Senator.

Senator CONNALLY. Do you have two others or one other?

The CHAIRMAN. Two others, but they are both very brief.

Senator CONNALLY. I have a gentleman who is waiting here from my State. It will only take 2 minutes.

The CHAIRMAN. We will call him next.

Mr. PRIESTLEY. I now call your attention to the galley proof showing the working method of this tax. I have taken but one industry—the printing, publishing, and allied trades—and have reduced the picture until I found identical establishments producing under similar conditions. I picked the book-producing companies in order to better explain my plan.

(The following was submitted by Mr. Priestley:)

FROM THE UNITED STATES BUREAU OF THE CENSUS, CENSUS OF MANUFACTURING FOR 1939, PRINTING, PUBLISHING, AND ALLIED INDUSTRIES

There were 24,878 such establishments in 1939 producing a volume of business amounting to $4,344,921,146, made up as follows:

There were 9,595 general commercial (job) printing doing $515,485,609; fair amount, $54,000.

There were 6,878 newspapers—publishing and printing, $898,225,000; fair amount, $131,000.

There were 1,958 periodicals—publishing without printing, $266,831,618; fair amount, $136,000.

There were 1,133 bookbinding and related industries, $102,591,313; fair amount, $91,000.

There were 749 lithographing and photolithographing (inluding preparation of stones or plates and dry transfers), $154,394,787; fair amount, $206,000.

There were 694 photoengraving—not done in printing establishments (including preparation of plates), $55,619,445; fair amount, $80,000.

There were 690 books—printing, without publishing, $87,656,088; fair amount, $127,000.

There were 641 machine and hand typesetting (including advertisement type setting), $25,096,497; fair amount, $39,000.

There were 600 periodicals—publishing and printing, $202,015,136; fair amount, $337,000.

There were 556 books—publishing without printing, $109,579,003; fair amount, $197,000.

There were 436 engraving—steel, copperplate, and wood—plate printing, $22,163,638; fair amount, $51,000.

There were 431 newspapers—publishing without printing, $11,963,611; fair amount, $28,000.

There were 234 electrotyping and stereotyping not done in printing establishments, $29,045,159; fair amount, $124,000.

There were 150 books—publishing and printing, $39,517,202; fair amount, $264,000.

There were 109 greeting cards (except hand painted), $39,715,439; fair amount, $365,000.

There were 24 gravure, rotogravure, and rotary photogravure (including preparation of plates), $18,614,837; fair amount, $776,000.

The example explaining the way the Federal graduate gross tax works:

150 BOOK PUBLISHING AND PRINTING ESTABLISHMENTS

[Volume of business, $39,517,202; fair amount, $264,000]

34 establishments did less than $20,000: Tax at ¼ of 1 percent	$50
39 establishments did less than $50 000: Tax at ¼ of 1 percent	125
20 establishments did less than $100,000: Tax at ¼ of 1 percent	250
28 establishments did less than $250,000: Tax at ¼ of 1 percent	625

150 BOOK PUBLISHING AND PRINTING ESTABLISHMENTS—Continued

9 establishments did less than $500,000:	
$264,000, at ¼ of 1 percent	$660
$236,000, at ½ of 1 percent	1,180
Total tax on $500,000	1,840
9 establishments did less than $1,000,000:	
$264,000, at ¼ of 1 percent	660
$264,000, at ½ of 1 percent	1,320
$264,000, at ¾ of 1 percent	1,980
$208,000, at 1 percent	2,080
Total tax on $1,000,000	6,040
8 establishments did less than $2,500,000:	
$264,000, at ¼ of 1 percent	660
$264,000, at ½ of 1 percent	1,320
$264,000, at ¾ of 1 percent	1,980
$264,000, at 1 percent	2,640
$264,000, at 1¼ percent	3,300
$264,000, at 1½ percent	3,960
$264,000, at 1¾ percent	4,620
$264,000, at 2 percent	5,280
$264,000, at 2¼ percent	5,940
$128,000, at 2½ percent	3,020
Total tax on $2,500,000	32,720
8 establishments did less than $2,500,000:	
$264,000, at ¼ of 1 percent	660
$264,000, at ½ of 1 percent	1,320
$264,000, at ¾ of 1 percent	1,980
$264,000, at 1 percent	2,640
$264,000, at 1¼ percent	3,300
$264,000, at 1½ percent	3,960
$264,000, at 1¾ percent	4,620
$264,000, at 2 percent	5,280
$264,000, at 2¼ percent	5,940
$264,000, at 2½ percent	6,600
$264,000, at 2¾ percent	7,260
$264,000, at 3 percent	7,920
$264,000, at 3¼ percent	8,580
$264,000, at 3½ percent	9,240
$264,000, at 3¾ percent	9,900
$264,000, at 4 percent	10,560
$264,000, at 4¼ percent	11,220
$264,000, at 4½ percent	11,880
$248,000, at 4¾ percent	11,780
Total tax on $5,000,000	124,640

Approximately 2½ percent on the total business.

Mr. PRIESTLEY. If you will look at the galley proof you will see there that the United States Bureau of Census has given the facts and figures appertaining to all of the different businesses and after I had that, I subdivided the book publishing and printing establishments.

They did a volume of business amounting to $39,000,000, and their fair amount, which I have explained before, was found by dividing that amount by the number of enterprises, it gave a fair amount of $264,000.

There were 93 establishments out of the 150 which did less than the fair amount. Their tax on their total business would amount to one-fourth of 1 percent.

There were nine establishments which did approximately $500,000, therefore, they would pay $660 as one-fourth of 1 percent of the first $264,000. They would pay one-half of 1 percent on the next part of the $500,000.

Now, if we go down the line to the other establishments, you will find that there were nine which did $2,500,000. Their tax would be $32,720.

There were three establishments which did approximately $5,000,000. Their tax would be $124,640. This would approximate on the larger ones but 2½ percent on their total business.

Gentlemen, I would like to have that inserted, too [indicating], in the record, if you please.

The CHAIRMAN. Yes. You may put it in.

Mr. PRIESTLEY. Showing how this is deducted and showing the need of such a tax.

The CHAIRMAN. Yes; you may put it in the record.

Thank you very much.

(The statistics referred to by Mr. Priestley are as follows:)

Summary for establishments classified according to value of products

Size of establishments classified according to value of products	Approximated profit for each establishment, not accounting for advertising, depreciation, insurance, etc.	Number of establishments	Average number of wage earners in each establishment	Wage earners (average for the year)	Average yearly wage paid each worker	Total wages according to class	Total value of products according to class	Average value of production per wage earner in each class	Total value added by manufacturers according to class	Average value added by manufacturers per wage earner in each class
All establishments		166,794		8,569,231		$10,112,882,711	$60,712,871,737		$25,173,538,913	
$5,000 to $19,999	*$3,881*	50,549	3½	161,896	*$807*	130,709,644	576,966,403	*$3,570*	327,064,652	*$2,020*
$20,000 to $49,999	*9,852*	37,611	8	305,036	*852*	284,181,955	1,214,034,452	*3,980*	659,543,513	*2,161*
$50,000 to $99,999	*20,864*	23,661	16	385,439	*977*	376,843,851	1,683,660,654	*4,370*	879,269,714	*2,281*
$100,000 to $249,999	*43,680*	23,422	32	763,574	*992*	757,118,563	3,739,972,822	*4,878*	1,790,923,615	*2,357*
$250,000 to $499,999	*94,289*	12,763	67	857,354	*1,005*	861,794,943	4,511,524,385	*5,274*	2,076,254,427	*2,422*
$500,000 to $999,999	*191,516*	8,936	127	1,128,224	*1,098*	1,168,276,055	6,279,012,018	*5,565*	2,834,342,924	*2,513*
$1,000,000 to $2,499,999	*407,115*	6,098	249	1,517,198	*1,106*	1,677,585,763	9,396,817,829	*6,200*	4,157,930,600	*2,741*
$2,500,000 to $4,999,999	*937,920*	2,130	480	1,021,809	*1,228*	1,254,945,814	7,327,151,531	*7,180*	3,251,714,648	*3,182*
$5,000,000 to $24,999,999	*2,670,552*	1,425	*1,078*	1,527,333	*1,401*	2,139,437,006	14,303,847,840	*9,365*	5,723,913,776	*3,892*
$25,000,000 and over	*8,775,660*	228	*5,953*	901,368	*1,628*	1,462,009,117	11,679,883,803	*12,959*	3,463,081,044	*3,849*

Roman figures are an exact duplicate of the figures from the Census Bureau. *Italic figures* are deductions made therefrom by T. J. Priestley, Jr.
This table shows the aggregate of all manufacturers, but the figures for all identical businesses show more pertinent facts for manufacturing, farming, merchandising, banking, etc.

Source: Department of Commerce, Bureau of the Census, Washington—Census of Manufacturers, 1937.

The CHAIRMAN. Mr. Hardgrave.

STATMENT OF ARTHUR HARDGRAVE, REPRESENTING THE PEPSI-COLA BOTTLING CO., CHICAGO, ILL.

Mr. HARDGRAVE. My name is Arthur Hardgrave. I represent the Pepsi-Cola Bottling Co., of Chicago. I wish to discuss the burdensome provisions of the present excess-profits-tax law with particular reference to the inadequacy of the existing relief provisions and those included under section 722 of House bill H. R. 7378.

At the outset I wish to make clear that I have no desire to criticize the rates in H. R. 7378. Whatever rates may be necessary to finance the war are acceptable to our company.

The prevailing opinion is that Congress desires to and will endeavor to enact such provisions as will give some major relief to companies which began business either immediately before or during the base period and whose operations have expanded as a result of normal business growth. It is my considered opinion that the existing law affords little relief to companies of this nature. And, after close study of the relief provisions of H. R. 7378, I conclude that it would be extremely difficult for companies such as these to obtain any substantial relief from the tax burden which will be imposed upon them and which I believe is highly discriminatory.

In order that I may present the problems of our company, I shall give you below a brief history of its existence.

Our business is the manufacture and sale of Pepsi-Cola in four counties of northeastern Illinois under a license from the Pepsi-Cola Co. of Delaware.

We were incorporated on December 20, 1935, and began business on January 1, 1936.

We began business with an authorized and issued capital stock of $20,000, and during the first year employed 24 people. As of this date, the company owns one modern bottling plant constructed in 1938 and 1939, costing approximately $140,000, and occupies under lease arrangement a second plant constructed and placed in operation during 1941 at a cost of approximately $700,000. Currently we are employing, in manufacturing and distributing, 453 people, a considerable number of whom are women.

Senator CONNALLY. You put the stuff in bottles?

Mr. HARDGRAVE. Yes, sir; we do.

Senator CONNALLY. How does the present bill change the existing law?

Mr. HARDGRAVE. Well, the existing law, if you will bear with me for a moment, doesn't give us relief because there is an onerous burden of proof upon the taxpayer which we haven't been able to get around.

The growth of our company has materially contributed to the economic income of the working people without interfering with the war program.

Our surplus at December 31, 1941, was $37,562.67. The capital and surplus of the business are all invested in working capital and operating plant. Our net sales for the years 1936 to 1941, inclusive, our net income before Federal tax for the same years, our Federal taxes, and our net income after Federal taxes was as shown in the following

tabulation marked "Exhibit A." On the third page I give you a little exhibit:

	1936	1937	1938	1939	1940	1941
Net sales	$304,076.34	$548,000.25	$683,776.87	$1,217,766.24	$1,861,060.74	$3,375,149.42
Net income before Federal taxes	19,243.12	31,819.11	34,546.11	106,892.07	211,097.11	435,317.16
Federal taxes	3,491.91	3,776.48	5,988.20	18,454.49	88,762.65	249,871.98
Net income after Federal taxes	15,751.21	28,042.63	28,557.91	88,437.58	122,334.46	185,445.18
Percentage of Federal taxes to net income before Federal taxes	Percent 18.15	Percent 11.86	Percent 17.33	Percent 17.26	Percent 42.05	Percent 57.40

In 1941 we paid 57.4 percent of our earnings. My competitor in Chicago who had good earnings during the base period, paid out 31.6 of his earnings during 1941.

Senator BROWN. That is Coca-Cola?

Mr. HARDGRAVE. That is Coca-Cola; yes, sir. I just refer to them as my competitor only. There are other companies who have been in business for a great many years paid out from 31 to 42 percent of their earnings last year for taxes.

Senator CONNALLY. Do you pay a royalty to some concern?

Mr. HARDGRAVE. No royalty except we buy our concentrate from the Pepsi-Cola Co. in Long Island and we bottle it and sell it.

Our margin of profit is not as great as some of the other corporations which have been in business a long time.

For the year 1941, Federal taxes took 57.4 percent of our net income before taxes. While we have an increased market demand during 1942 approximating 100 percent over the year 1941 and have provided increased manufacturing facilities to handle our expected 1942 volume, yet, due to the Government rationing, our sales and net income will fall below that for 1941. However, assuming that we have the same net income for 1942 as we had for 1941, the rates proposed under H. R. 7378 will take approximately $348,000 or 80 percent of our net income before taxes, leaving the company only $87,000 for corporate purposes. I do not see how we can continue in business with only $87,000 left for I think it will require at least $150,000 or approximately 35 percent of our net income. Our principal competitors, who were established long prior to the base period and, therefore, were able to reach their growth and establish normal earnings before 1936, paid taxes for the year 1941 ranging from 31 percent to 42 percent of their net income, and I assume that the relative positions of our company and our competitors will be the same for 1942 under the provisions of H. R. 7378. I believe that this is discriminatory taxation.

I do not believe that Congress desires to impose any unusual burdens upon or discriminate against these young growing companies in favor of old, seasoned corporations which enjoyed good years during the tax base period and which, as expressed by one executive, are "riding in the golden seat" while these young, growing companies are doing their best to hold on while riding in the bumper seat.

I do not believe that anyone desires to dispossess anyone who is riding in the golden seat. The fact is that I would enjoy riding with them. But it does seem to me that if any relief is given to anyone

in this bill or consideration given to the problems of any class of business, then these young, growing companies should not be forgotten or overlooked because they are small and because the owners or executives of these young companies, generally speaking, are timid, inarticulate, and lack the initiative to come to Washington and appear before your committee and voice their problems and burdens.

Gentlemen, they are afraid to come down to Washington to appear before you. I have talked to a lot of them.

Senator CONNALLY. You are not afraid, are you?

Mr. HARDGRAVE. I have to do this, Senator. I have reached the point where I don't see how we can exist any longer.

If you will recall this is the first time I have been here.

Senator CONNALLY. We don't object to you coming.

Mr. HARDGRAVE. I have been sitting in the back seat watching you for several years, but I didn't have the courage to talk to you.

The CHAIRMAN. How much total capital do you have invested?

Mr. HARDGRAVE. In the combined properties about $850,000. We borrowed $100,000 this year to pay for equipment which we expected to use. Orders were placed prior to the Pearl Harbor incident.

The CHAIRMAN. How do you expand your business so rapidly with sugar rationed and the caps rationed?

Mr. HARDGRAVE. We are not expanding now, Senator. As I say, we built this plant and we bought this equipment last August and September, and we expected to do 10,000,000 cases of business in Chicago this year. We will sell less than we did last year. We have had to raise our prices some, but then I don't believe we can get by on $87,000 after payment of taxes required under the House bill.

If you impose the present law on our competitors' income, they will pay 65 or 70 percent of their income on present taxes.

The CHAIRMAN. All right, go ahead.

Mr. HARDGRAVE. Some of us, gentlemen, have reached the afternoon of life. We have had much experience and undoubtedly are wise in the ways of man and business, but the young must be nurtured and assisted if they are to endure the hardships of the present moment and go into the post-war period sound and able to take their rightful position in American business and as American individuals. These young, growing companies are at the moment struggling to get a foothold in American industry.

By growth companies, I mean those which commenced business either during or immediately prior to the base period or those whose capacity for operation or production increased during the base period or immediately thereafter solely as a natural result of the normal operation of the business and not as a result, directly or indirectly, of the war effort, and whose normal earnings base is so low, compared with their current rate of earnings, that application of the credits and rates approved by the House would mean that their taxes would be equivalent to 80 percent to 85 percent of their net earnings for the year 1942.

Quoting from memory, I recall that during the hearings of the House Ways and Means Committee it was stated that the Treasury is expected to levy taxes to the extent of about 61 percent of corporate income for the year 1942. If 61 percent, or 65 percent, is required by the Government, then Congress should see that such provisions are placed in the bill which will prevent discriminatory tax burdens.

Not only is the relief granted under the existing revenue act inadequate, but the Commissioner of Internal Revenue has adopted regulations which, as a practical matter, make it impossible for any growth corporation to present a case which will obtain relief. This is for the reason that the Commissioner has taken the position that the corporation must prove that it would have sold the increased production it would have been able to produce. This requirement of strict proof of results which might have been accomplished had certain conditions existed does not result in a showing of normal earnings from increased productive capacity for the purpose of an excess-profits tax based upon a comparison of normal earnings with earnings during an excess-profits tax period.

I have closely studied section 213 of H. R. 7378, amending section 722, the general relief section, of the Internal Revenue Code. I believe that the wording of the proposed amendment of that section continues the requirement for strict proof now imposed by the Commissioner for the reason that the taxpayer is required to establish what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income. According to Webster, "establish" is defined: "To put beyond doubt or dispute; as to establish a fact, principle, and so forth."

I believe that Mr. C. F. Hotchkiss, Jr., a witness appearing before your committee on July 30, had in mind the onerous burden of the taxpayer in proving the need of relief when, referring to the relief measures contained in H. R. 7378, he stated:

> However, these measures are not specific, and are subject to the judgment of the reviewing body. Furthermore, much time would elapse in the review of our case, and the probabilities of relief could not be used as collateral at a bank.

To relieve the small taxpayers of the onerous burden of proving something which might have happened had certain conditions existed, I suggest that section 722 be amended so as to remove the requirement that they establish beyond doubt or dispute what their constructive base period income would have been and so as to provide that they shall be granted relief upon a showing, sufficiently complete as to convince a reasonable-minded person, of what his net income could have been had he had the available facilities during the base period. I believe that such a result could be accomplished by amending section 722 (a) and (b) as contained in H. R. 7378, as follows:

(1) Section 722 (a), general rule, delete the following:

> and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess-profits tax based upon a comparison of normal earnings and earnings during an excess-profits tax period.

With this change the sentence in question read:

> In any case in which the taxpayer establishes that the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax, the tax shall be determined by using a constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter.

The reason for the above change is to eliminate the onerous responsibility of establishing a fair and just amount to be used as a constructive normal earnings base.

(2) Immediately after the amended sentence discussed in (1) above, add a new sentence to read:

Such constructive average base period net income shall be a fair and just amount representing normal earnings for the purposes of an excess-profits tax based upon a comparison of normal earnings and earnings during an excess-profits tax period.

The reason for the change in the wording as outlined above is to define what the constructive average net income base should be.

(3) Add the following words to the last sentence of section 722 (a):

except as hereinafter in this section provided.

By adding the above sentence, certain events which did occur after December 31, 1939, may be taken into account.

(4) Add an additional sentence at the end of the general rule in section 722 (a) to read:

For the purposes of this section the limitation imposed by section 713 (f) (6) shall not apply.

This sentence is added in order that true relief may be granted a growth corporation under the alternative method of computing the excess-profits credit provided in section 713 of the existing law. Under existing law and under the provisions of H. R. 7378, no corporation may have an excess-profits credit greater than the income of the best year in its base period. This restriction results in a serious limitation upon the relief granted to some corporations and to other corporations it prohibits the granting of any relief at all. Therefore, if true relief is to be granted those young growing companies, I believe that their excess-profits credit computed under the alternative method permitted by section 713 should not be limited to the highest income for any year during the base period.

(5) Amend the last sentence of section 722 (b) (4) to read as follows:

Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of commitments made prior to January 1, 1940, binding the taxpayer to make the change, or as a natural result of the normal growth of the business, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business or—

The purpose of this amendment is to eliminate the restriction contained in section 722 (a) that events or conditions affecting the taxpayer occurring or existing after December 31, 1939, shall not be taken into account and to permit events and conditions occurring after December 31, 1939, to be given effect to in determining constructive base period net income if such events or conditions are a natural result of the normal growth of the business.

As an illustration of the relief which I ask, let us assume that a young, growing corporation had excess-profits net income during the base period of the following amounts:

1936	$30,000	1938	$80,000
1937	30,000	1939	110,000

Under section 713 the corporation would be entitled to an excess-profits credit of $104,500. If this corporation grows as ours has done and it has an excess-profits net income of $500,000 for 1942 solely as a result of natural growth from normal operation it will pay combined income and excess-profits taxes of $402,975, or 80.59 percent.

Let us assume further that the corporation can make a showing—but not prove—that it could have made the following amounts if it had had the same productive capacity in the base period as it had in 1940 and 1941:

1936	$90,000	1938	$250,000
1937	140,000	1939	450,000

The constructive average base period net income computed under the suggested amendments would be $450,000, producing an excess-profits credit of $427,500. The combined income and excess-profits taxes then would be $257,625, or 51.52 percent. This would result in a tax comparable in percent to that paid by our competitors.

I also believe that the present method of computing the excess-profits tax before computing the normal tax and surtax is wrong in principle. If the tax is to be based on true excess profits, I firmly believe that it should be computed upon the profits remaining after deduction of the normal tax and surtax because I believe that you cannot justly determine what constitutes excess profits until after other Federal taxes have been provided for. In justice, only those profits which are truly excess profits should be the base for an excess-profits tax, not total profits. Therefore, I urge that the method of computation be changed so as to provide for the deduction of the normal tax and the surtax to arrive at the excess-profits tax base. The rates of the normal and surtax can be placed at such a point that the desired revenue will be produced, and I am sure that this will meet with no objection from American industry. I, for one, know that I have no objection.

As an added measure of relief to those corporations using the earnings method of computing their credit, I believe that the base period should be extended so as to include the year 1940 and that taxpayers should be permitted to use the best 4 out of the 5 years in computing the average, or at least the best 4 consecutive years of the 5. This would afford a deserved measure of relief to those corporations which either had little or no earnings during the 4 years 1936 to 1939, but returned toward normal in 1940.

As a concluding statement, I wish to point out that the tax burden imposed upon our company by H. R. 7378 as it was passed by the House, would be so great that our working capital would be depleted and entirely inadequate to conduct our business even under the restricted rationing program of the Government.

As of June 30, 1942, we had approximately $380,000 tied up in inventories and accounts receivable. Our company, which is slightly over 6 years old, has not been in business long enough to build up adequate reserves to continue in business while utilizing 81 percent of its earnings for the payment of Federal taxes.

We seek relief because we wish to continue in business and remain a part of the American industry program during the post-war period. Our business is a depression business, and, therefore, is in a position

to contribute, and will contribute as far as it possibly can, to the employment problem during that period when it may be badly needed.

I thank you, gentlemen, for your indulgence in receiving my views.

The CHAIRMAN. Doesn't this bill give some relief to a growth company?

Mr. HARDGRAVE. No, sir. I think if you will study it carefully, it does not. It gives some relief, but as I will point out to you a little later on, section 713 (f) (6) nullifies the relief given as enacted by the House under section 722.

The CHAIRMAN. I am curious to know, though, whether you really have been observing the sugar rationing?

Mr. HARDGRAVE. Yes, sir.

The CHAIRMAN. Absolutely?

Mr. HARDGRAVE. Right to the letter, sir.

The CHAIRMAN. Right to the letter?

Mr. HARDGRAVE. Yes, sir.

The CHAIRMAN. You buy concentrate?

Mr. HARDGRAVE. From the Pepsi-Cola Co. of Long Island.

The CHAIRMAN. And then you do your own mixing?

Mr. HARDGRAVE. Yes, sir.

The CHAIRMAN. And your own bottling?

Mr. HARDGRAVE. Yes, sir.

The CHAIRMAN. And your own caps?

Mr. HARDGRAVE. Yes, sir.

The CHAIRMAN. Are all your people all over the country running under last year?

Mr. HARDGRAVE. I can't answer for that. They are running all the way from 17 to 22 percent under last year.

The CHAIRMAN. I have made some little inquiry in that very field. I don't think the growth period has been the same with all of them.

Mr. HARDGRAVE. Off the record?

The CHAIRMAN. Off the record.

(Discussion had off the record.)

Mr. HARDGRAVE. I am trying to stay within the rules and regulations, but I must say that I am struggling hard. If I can get an extra crown or an extra bag of sugar, I am going to take it.

Senator DANAHER. I think you said, Mr. Hardgrave, that under the House bill, in section 722 (f) (6)——

Mr. HARDGRAVE. No; section 713 (f) (6). That is not in this new draft, Senator.

Senator DANAHER. I was wondering wherein you found it inadequate.

Mr. HARDGRAVE. Well, I don't know that I can read the phraseology correctly in this bill, and I don't set myself up as a tax expert, gentlemen, but my auditors and income-tax men tell me that any relief that we get under section 722 is nullified because section 713 (f) (6) states that the relief provisions in that section make it impossible for you to establish a tax-base period in excess of the maximum earnings for any 1 year of that tax-base period.

Senator DANAHER. A further question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator DANAHER. Under section 722 it gives you an opportunity to establish what would be a fair and just amount representing nor-

mal earnings to be used as a constructive average base period net income?

Mr. HARDGRAVE. Yes, sir.

Senator DANAHER. Now, then, what is your trouble under that?

Mr. HARDGRAVE. My trouble under that is that section 713 (f) (6) has not been amended and so my fellows tell me it stops the relief granted that you have just read there; section 713 (f) (6). I hope that you are right, sir.

Senator DANAHER. Well, I would like very much to have you make clear wherein we are not right in what we are trying to do because certainly those relief provisions are intended to take care——

Mr. HARDGRAVE. I think that is true.

Senator DANAHER. Of corporations that are situated as you are and and to give you an opportunity to construct an average base period net income if you can establish one.

Senator BROWN. Mr. Stam, the counsel for the Joint Committee on Internal Revenue Taxation says that you are wrong about your statement that section 713 (f) (6) has not been modified. He says it has and that it does not limit the relief provided in section 722.

Mr. HARDGRAVE. I am glad to hear that. I did not find it any place in this bill where it had been amended. I don't know. I had a very brief talk with Mr. Stam shortly after the House committee had concluded its hearings.

Senator BROWN. He said the House bill is not subject to section 713 (f) (6), which is the limitation that you are talking about.

Mr. HARDGRAVE. Yes, sir.

Senator BROWN. That is very plain.

Senator DANAHER. Yes; I think so.

Mr. HARDGRAVE. In section 713 (f) (6), there is a limitation——

Senator BROWN. And it does not apply to the relief granted under section 722. I know this from some study of the matter when we had it up in the last tax bill that your criticism of section 722 is just contrary to the attitude that the committee now takes. The Ways and Means Committee felt when section 722 was first enacted or first modified and put substantially in its present form in the present law, that we should have gone much further than we did and allow a much wider discretion to the Commissioner than was done when section 722, as in the present law, was enacted. Senator George took that position on the floor and in conference. I remember that very well, because I was much interested in it in behalf of certain Michigan companies, and we felt then that we didn't go far enough in giving the Commissioner wide discretion. So, as was stated the other day in a discussion with the Treasury, the Treasury has come around to Senator George's idea—the present chairman—and believes that the only way that adequate relief can be given is by vesting a wide discretion in the Commissioner, because cases that come up are so different in effects, in their nature, that it is impossible to write a statute or to establish standards that would cover every conceivable case, so section 722 does vest a much wider discretion than the present law, and we think that is in the interest of relief for corporations like yourself.

Mr. HARDGRAVE. I trust, sir, that you are right. May I explain this: That we applied for relief under the existing law.

The CHAIRMAN. Now, that is true, Mr. Hardgrave, before the last amendment that is in the bill now. I can see how you would have been cut off from relief under existing law, but this bill, as it comes from the House, is intended to reach your case. I do not know whether there is any technical difficulty standing in the way of it or not.

Mr. HARDGRAVE. I think that is true, Senator, but may I respectfully suggest, sir, that I employed two of the best tax experts that I could find in Chicago, one of whom is George Rossetter, and since the bill was published I have had them working day and night on it, to try to tell me what relief we could get under this bill. They came out very frankly and said we could not get very much relief under it. There are two phases of it. I can explain by telling very briefly what we did last year. We applied for relief. We filed application for refund for our 1940 taxes. They, the revenue agents, made quite an extensive investigation of all of our books and affairs. The Treasury very frankly said, "We are sympathetic with you. We think you are entitled to relief because of the situation here, but we are not going to grant it to you because you can't prove to us beyond any question of a doubt that you could have sold a greater volume of business had you had the money and the capacity to have done so."

Senator BROWN. That was because the standards in old section 722 were considered to be limitations?

Mr. HARDGRAVE. That is right, sir.

Senator BROWN. Now, we strike out those limitations in the new section 722 to a very large extent and I think it is in the interest of just what you are after.

Mr. HARDGRAVE. When I first read section 722 and the relief it was intended to grant, it pleased me very much; but as I say, in this memorandum here, after studying this very carefully, we believe that the present bill heaps upon the taxpayer the onerous burden of proof as to what he could have done. He must establish beyond any question of doubt that he could have done a greater volume of business.

Senator BROWN. I don't know what you mean by onerous burden of proof. Certainly in any event it ought to be on you, when you are asking for special relief. I think you should prove your case. But it seems to me that by eliminating these standards which are construed to be limitations, that you have got a better chance than you had before. I grant one thing in your criticism. I think that it would be best if we would establish a special three- or five-man board to take care of these cases and not leave it to the Commissioner of the Board of Tax Appeals, so that it could be done expeditiously. You mention here that you fear that it will take a long time.

Mr. HARDGRAVE. Yes; I do.

Senator BROWN. I think we ought to expedite it some way.

Mr. HARDGRAVE. I make certain suggested changes in the phraseology. They are simple, innocuous, I think, except that they do give us relief if you gentlemen would care to consider that in committee.

The CHAIRMAN. Yes, sir; we will be glad to.

Mr. HARDGRAVE. I hope you do that. And I also set up some illustrations here showing just what I mean and how it would affect us and the figures given in this illustration on page 8 very closely approximate our figures, I assure you of that.

The CHAIRMAN. Yes, sir; I have just been looking it over.

Senator DANAHER. Mr. Chairman: A further question.

The CHAIRMAN. Yes, Senator Danaher.

Senator DANAHER. If you have, Mr. Hardgrave, any ideas other than those proposed amendments that are contained in this memorandum as to how a constructive base can be set up which will apply specifically to growth corporations, send them along through your accountants, if you like.

Mr. HARDGRAVE. That is an awful headache, sir; but I will try.

Senator DANAHER. Well, you want us to do it.

Mr. HARDGRAVE. Yes, I know, but, as I explained, I think probably I have some suggestions that I could make. One of them is contained a little further on.

Senator DANAHER. Which I have read and which I don't think applies in the light of the discussion that we have had, but if you have any other ideas, after this discussion, and after you have talked with your accountants, as to how to give a constructive base which will afford adequate relief to you and yet not widen the thing entirely——

Mr. HARDGRAVE. I appreciate your problem on that.

Senator DANAHER. I would like to see your thought on it.

Mr. HARDGRAVE. I have thought over that for quite a length of time, and I get back to the same story also that the discriminatory features of it force us to have to pay this year 80 to 84 percent of our earnings out in taxes, I believe it will be. I hope not. I hope that you are entirely right.

Sentor DANAHER. What you say applies to any company that started business today, for example?

Mr. HARDGRAVE. Yes.

Senator DANAHER. And consequently you have got the same problem for any growth corporation?

Mr. HARDGRAVE. The growth corporations are the very ones that need a little nurture and assistance at the moment.

Senator DANAHER. I agree with you.

Mr. HARDGRAVE. We didn't know, of course, that the Japs were going to bomb Pearl Harbor and had we known that, we would have reduced our expenditures for the year.

Senator BROWN. Had we known they were going to bomb Pearl Harbor, it wouldn't have happened.

Mr. HARDGRAVE. I agree with you on that. Thank you very much.

The CHAIRMAN. Thank you. We will give consideration to the questions raised in your brief.

(The brief referred to is as follows:)

PEPSI-COLA BOTTLING CO. OF CHICAGO,
Chicago, Ill., August 18, 1942.

The Honorable WALTER F. GEORGE,
Chairman, Committee on Finance, Senate Office Building,
Washington, D. C.

SIR: At the time I appeared before your committee on August 5, both Senators Brown and Danaher requested me to give your committee any further ideas we may have concerning the proposed relief amendments contained in section 722, H. R. 7378, especially referring to an adequate, constructive tax base which would afford relief to young, growing companies and yet not widen the thing entirely.

I have discussed this matter at some length with our tax consultants here in Chicago, advising them of the statement which Senator Brown made to the

effect that, "Mr. Stam, the counsel for the Joint Committee on Internal Revenue Taxation says that you were wrong about your statement that section 713 (F) (6) has not been modified. He says it has and that it does not limit the relief provided in section 722."

We are willing to accept the statement of Mr. Stam and Senator Brown to the effect that section 713 (F) (6) does not limit any constructive average base period net income which may be determined under the relief provisions in section 722. However, if this is a fact, then I do not see any objection to adding the additional sentence at the end of general rule in section 722A to read:

"For the purpose of this section the limitation imposed by section 713 (F) (6) shall not apply."

In my opinion, the addition of this sentence takes away from the act, at least to a certain extent, any controversial aspect relating to this section.

The clarification of any possible effect which 713 (F) (6) may have upon the new relief provision leaves one other important factor which, we feel, should be corrected. Namely, giving the taxpayer an opportunity to establish the constructive average base period net income reasonably free of the onerous burden of proof to which I referred in my testimony.

When appearing before the committee, Senator Brown stated that in any event the burden of proof should be on a taxpayer asking for relief. We are agreeable to assuming that responsibility providing the regulations are sufficiently flexible and reasonable. In this connection may I respectfully discuss briefly with you the question of regulations.

After close study of our relief problem—particularly in the light of our experience under section 722 of existing law—I come to the conclusion that our failure to secure relief is due to an unduly technical definition by the Commissioner of the standards set by Congress for the granting of relief. I believe that a similar technical definition, or interpretation, can, and may, be made by the Commissioner of standards set in H R. 7378. For this reason I ask that the technical barrier be removed so that relief will be granted to deserving taxpayers without requiring them to accomplish the impossible in measuring up to the statutory standards.

The statutory requirement of which I speak is that which requires the taxpayer to "establish" a constructive base period income. My dictionary defines "establish" to mean: "to put beyond doubt or dispute; as to establish a fact, principle, etc." I judge that the Commissioner uses the same dictionary.

I respectfully submit that one cannot "establish," that is, prove beyond doubt or dispute, a fact that never did exist or an occurrence that never happened. Yet that is exactly what the statute and the Commissioner require when they make the taxpayer establish a constructive base period net income in order to get relief from excessive taxation.

Relief may be obtained under section 722 of existing law "if the taxpayer establishes * * * the amount that would have been its average base period net income" under specified circumstances. Section 30.722-3 of Treasury Regulations 109 relates to the dtermination of substitute average base period net income. The Commissioner interprets the statute in those regulations to require that "the taxpayer must establish the amount that would have been its average base period net income."

The House Ways and Means Committee report and that of the Senate's Committee on Finance on the 1941 bill (H. R. 8531, 77th Cong., 1st sess.) both state that "In constructing its average base period net income * * * a low physical volume of sales owing to low demand for such product, or for the output of the taxpayer during the base period would not be considered as making the net income abnormal." The regulations (sec. 30.722-3) paraphrase the language of the committees' reports and add the following example:

"Thus, for example, in the case of a corporation which in 1939 changed the character of its business from the manufacture of typewriter parts to the manufacture of rifles, a reconstruction of the excess-profits net income of such a corporation for the taxable years in i s base period as a manufacturer of rifles would have to take into consideration, among other factors, the actual demand for such rifles in 1936, 1937, and 1938."

Now, the amended section 722 contained in H. R. 7378 continues the requirement that the taxpayer establish what its constructive base-period income would have been. Therefore, the taxpayer will be subject to the same provisions of strict proof as under existing law.

Our dilemma results from the fact that we began the manufacture and sale of a new product in 1936. There was no demand for it other than the demand we created by our own sales efforts and advertising.

We created a market demand each year far in excess of the productive capacity we could provide from the limited capital available to us and from the bottling capacity we could secure from other bottlers in our area. In fact, we made serious endeavor, without success, to contract for much greater outside bottling capacity. We have never been able to supply the market demand.

Our directors, after carefully reviewing the market, were convinced that the company would be fully justified in financing through public subscription a large increase in productive capacity. Subsequent events have proven that our estimates were correct, yet we have been unable to establish the fact that low-volume sales of our product was not the fundamental reason for our low net income during the tax base period. Because of our inability to prove beyond doubt or dispute that a demand for our newly introduced product existed and that we could have sold as many cases of Pepsi-Cola in the base-period years as we sold in 1940 if we had had the same production facilities in those years as we had in 1940, we are denied relief and are compelled to pay excess-profits taxes at high rates on profits which are not in excess of what normal profits would have been under comparable circumstances. Base-period earnings and those of the taxable year must be on a truly comparable basis if the excess-profits tax is to be justly exacted.

We appreciate that we who seek special relief should bear the burden of showing that we are entitled to it. But we believe that we should not be made to accomplish the impossible feat of proving as a fact the existence of things which might have been but never actually were. We ask that, instead, we be permitted to demonstrate the reasonable probability of what our base-period income would have been with normal productive capacity and that we be granted relief upon that demonstration. For this reason we ask that your committee strike the word "establish" from section 722 and substitute therefor a requirement of a demonstration of "reasonable probability."

It seems to me that the tax bill should be strengthened to the point that the Commissioner would be required to grant relief under certain reasonable circumstances and conditions.

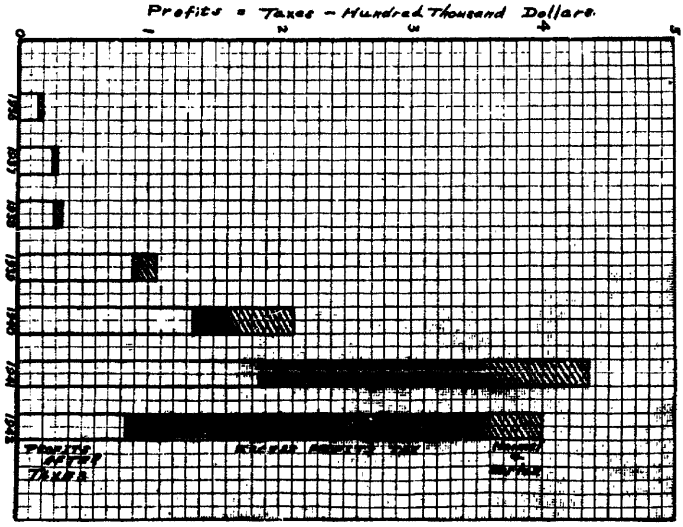
I have gained considerable satisfaction from the statement made by Senator Brown to the effect that both the House and the Senate desire to provide relief to growth companies. I trust that your committee will further strengthen the phraseology of section 722 to the extent that a taxpayer can obtain relief without long, drawn-out litigation or controversy. During my testimony, Senator Brown stated that he was willing to "grant one thing in your criticism. I think that it would be best if we would establish a special three- or five-man board to take care of these cases and not leave it to the Commissionor or the Board of Tax Appeals, so that it could be done expeditiously."

It is quite possible that this would be the best way to handle such cases for undoubtedly it would make it possible to administer the act through the securing of personnel big enough to handle this section the way it ought to be handled. The very fact that the growth corporation is in most cases a new corporation means that it does not have adequate reserve working capital to carry it through long controversial periods.

I am attaching hereto photostatic copy of a chart showing the extent to which our profits, after taxes, would be depleted in 1942 unless our company is able to establish a reasonable constructive base period net income. Our net earnings, before taxes, will decrease in 1942 over 1941 because of the Government sugar and crown restrictions. It will be noted that the profits, after taxes, unless we can obtain relief, will be below the point of diminishing returns. Furthermore, we cannot long operate if our working capital is continually dissipated through the payment of unjust and discriminatory excess-profits taxes.

This chart reflects the normal growth of our business resulting from heavy and extensive new business developments and advertising programs and further reflects the result of the continuous installation of increased productive capacity year by year since 1938. We have not prospered through the rearmament or war programs. On the contrary, we have been severely penalized because of the various restrictions. To correct this condition, I again urge your committee

to give consideration to amending the last sentence of section 722 B4, as suggested in my original statement filed with your committee. Furthermore, I believe that your committee should give serious consideration to including the year 1940 in the tax base period and permitting the taxpayer to use any 4 out of 5 consecutive years. This would give many a taxpayer the right to use the year 1940 which, after all, was a reasonable, normal earning year, especially for those companies that started in business during the tax-base period.



Assuring you that we appreciate your indulgence and consideration of the problems of a small company, I am,

Respectfully yours,

PEPSI-COLA BOTTLING CO. OF CHICAGO.
By A. HARDGRAVE.

The CHAIRMAN. Mr. McNeny.

STATEMENT OF FRANK L. McNENY, DALLAS, TEX.

Mr. McNENY. Mr. Chairman and members of the committee, I thank you most cordially for giving me 3 minutes time.

My name is Frank McNeny and I am in the real estate business in Senator Connally's domain in Texas, and I am representing myself primarily, but I presume to speak for all who invest in real property.

I want to discuss with you very briefly capital losses and bad debts.

Under the present revenue act a taxpayer reports 50 percent of his capital gains and may deduct 15 percent of his capital losses, but under the proposed revenue act he must offset his capital losses with capital gains in the same year, if a corporation. If an individual, he may deduct only $1,000 per year for 5 years, of any capital loss which he cannot offset with capital gains.

In other words, the proposed law says to the taxpayer, if you make a capital investment we are partners provided you show a profit, but if you sustain a loss it's all yours.

This applies to the purchase of all investment real estate and oil properties. Suppose a taxpayer sells a property for $25,000 or $50,000 profit. He must report 50 percent of it as a capital gain, but suppose he sells it for a loss of $25,000 or $50,000, the loss is his unless, perchance, he should have a $25,000 or $50,000 capital gain to offset it, and which is most improbable in the same year and which I think invites intrigue and chicanery and perhaps collusion.

It seems to me the spirit of the thing is wrong. It is like kicking a man when he is down. When a taxpayer sustains a heavy loss, that is the very time he needs the relief which a deduction would afford him. Certainly the spirit of fair play would say "report your gains, deduct your losses."

Therefore, I would like to see paragraph (d) of section 136 stricken from the proposed bill, restoring the present procedure on capital losses.

It cannot be an item that would seriously affect the tax receipts and yet I feel you are seriously penalizing the rest of the country in a doubtful attempt to forestall the practices of a few stock-market operators.

Then again the new law differentiates between business bad debt, and nonbusiness bad debt.

It would seem to me that a bad debt is a bad debt however incurred, and that the taxpayer should be allowed to deduct it.

You are surely not trying to limit a man's operations to his own business nor trying to destroy the profit motive if he should branch out in any other direction.

Take the illustrations in the committee's report under section 119. It says if A sells his business to B, but retains the receivables, B may deduct bad debts sustained in the business, but A may not deduct bad debts sustained in the receivables which were created by the business.

The report also says if A leaves his business to one son and his receivables to another son, the son who inherits the business may deduct his losses, but the son who inherits the receivables must bear his losses alone. These are manifestly unfair, to my way of thinking, if not downright immoral.

If I were writing a tax law--and you will excuse the impudence—I would make the rates as high as necessary to yield the amount desired, but I would avoid as far as possible anything that would breed discontent or disrespect for the law, or result in controversial discussions and appeals, and machinations of all kinds. More and more you are going to ask the taxpayers to pay and pay to provide the enormous sums we must spend to win this war, and I feel that the new revenue act should, in every paragraph, breathe the spirit of fair play.

I would, therefore, like to see paragraph 4 of section 119 stricken from the proposed act, restoring the procedure which prevails under the present law with reference to nonbusiness bad debts.

Now, I have a personal interest in both of these changes, but I say to you in all candor, and I believe Senator Connally will bear

me out in this, that I would not stand here and ask you to change a national law in order to give relief to me, were not the great principle of fair play involved in your dealings with all or a large segment of the taxpayers.

My problem is that in 1930 my late twin brother and I organized a $200,000 corporation and borrowed $750,000 for the construction of a large enterprise. This amount was supposed to be sufficient, but when the project was completed it was necessary for us to advance an additional $136,000 which was borrowed money. The corporation gave us its notes in this amount.

The project was ill-fated from the beginning because of the depression and other unforeseen economic factors and it is now on the shoals. The lender is foreclosing his lien.

I shall lose my stock in the corporation and the corporation's note for money advanced 12 years ago on which I have received 3 years' interest only.

The new Revenue Act says this loss is mine and I cannot even offset this year's income against it.

I have been a faithful taxpayer and believe me when I tell you I have been an enthusiastic one. I have always contended the income tax is the fairest tax in the world. I have shared my gains with the Government and the Government has shared my losses with me. It has been a partnership arrangement. That is the relationship which should exist between the Government and the taxpayers. Then as the country prospers, the Government shares that prosperity. The Government cannot prosper unless the country does prosper. Conversely, the Government certainly should not want to prosper at the expense of the individual.

And that is the very crux of the two changes I am requesting in the law.

Senator CONNALLY. In other words, if you and your brother lose five or six thousand dollars, you will not be able to take it in the profits you make this year?

Mr. MCNENY. That is right.

The CHAIRMAN. It is a harsh provision, you are quite right—the capital gains and losses provisions of the present law. It gets worse instead of better.

Senator CONNALLY. I wonder if we couldn't, Mr. Chairman, suggest that the Treasury study classifications of this kind. I am perfectly willing for these speculative and fly-by-night folks to be penalized, but where it is a normal and a business operation, it does seem to me a pretty cruel rule that you can take all a man's profits and then when he loses, he can't take any losses.

The CHAIRMAN. You are right about it. Thus far the Treasury has had but one yardstick by which to measure. That is the time in which you hold the assets.

Mr. MCNENY. On this money I am losing, as I have gained the money I have paid the income on it each year.

The CHAIRMAN. Yes; I know. I appreciate that fact.

We are glad to have heard from you.

Mr. Bodfish.

STATEMENT OF MORTON BODFISH, CHICAGO, ILL., EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS AND LOAN LEAGUE

Mr. BODFISH. Mr. Chairman, I think I can tell my whole story in just 5 minutes.

The CHAIRMAN. You are speaking to a particular provision?

Mr. BODFISH. I am speaking with regard to the specific section 153 commencing on page 158, inserting supplement U, sections 425, 426, and so forth, dealing with withholding or collection of tax at source on dividends, bond interest, and wages.

Senator CONNALLY. Mr. Bodfish, pardon me, but I have got to go. I am somewhat familiar with your statement, and I will peruse it later.

Mr. BODFISH. Thank you very much.

The CHAIRMAN. I wish the Treasury would note particularly because I presume this is a matter to be brought to the attention of the Treasury. All right.

Mr. BODFISH. There is only one thing that we want to make a suggestion about, and that is with regard to the application of the withholding provisions to dividends.

There has been a great deal of discussion in the course——

Senator BROWN. That is, dividends from building and loans?

Mr. BODFISH. From building and loan associations. Dividends from cooperative banks and savings and loan associations. Also dividends from credit unions and apparently from farm cooperatives, and possibly an even more extensive group than that.

There seems to have been no discussion of the dividend withholding question, and the situation is roughly this, speaking in terms of our savings and loan associations. We have 6,500,000 savers and investors and the withholding provision would require us in 1943 to withhold a dollar and a quarter on each member or investor. We would have to deal with this as a bookkeeping transaction either 2 or 4 times a year, dividing it up that much, write a letter to each saver or investor, ascertain if they were subject to the Federal income tax, get a reply back from him or, if not, withhold 5 percent of his dividends, give him 2 to 4 receipts, and transmit the nominal sums withheld to the Government.

Senator CLARK. It is just as much trouble in bookkeeping from an administrative standpoint to hold out $1.25 as it is $1,000?

Mr. BODFISH. Yes; it is our considered judgment that on these nominal amounts, the bookkeeping machinery, postage, labor, and correspondence costs involved, to the withholding institutions, the public, and the Government, probably approaches the amount that would be collected in advance or withheld.

Now, it seems to us in the drafting they have recognized the principle of avoiding withholding nominal amounts with regard to wages and salaries in setting the minimums. That has not been done with regard to dividends. We have been in conference with the credit-union people. They have about 10,000 credit unions scattered around the country with nearly 4,000,000 members. We find that on an average in 1943 they would withhold 15 cents, half of it each half of the year; in 1944, under the withholding provisions, 30 cents.

We really feel, Mr. Chairman, this is a matter which has been overlooked. We raise no question about the general policy on the withholding question particularly regarding wages and salaries. We do think that as regards dividends in nominal amounts that there will just be more expense and bookkeeping and paper work on the part of the Government, our institutions, and the individuals concerned than the amount of tax that would be collected in advance or at the source.

The CHAIRMAN. Do you suggest an amendment putting in a minimum?

Mr. BODFISH. We have an amendment. Our initial suggestion is to treat these small savers and investors in the same way apparently the draftsmen had planned to treat the savers in mutual savings banks and commercial banks. Section 153 of H. R. 7378 is rather carefully constructed so that it does not require banks with 35,000,000 savings and time depositors in mutual savings banks and commercial banks, to withhold on the interest they pay to savers and investors. Our amendment provides comparable treatment for savings and loan associations, credit unions, and farm cooperatives.

Now, I assume that the elimination of all bank interest was in order to avoid this rather onerous and nuisance type of bookkeeping and withholding on interest paid by banking institutions.

Senator VANDENBERG. Well, the Treasury has already had to take 10,000 new employees to run this section of the law from this end of the show. I can imagine what it might do to the rest of you.

Mr. BODFISH. I notice that in one of the earlier discussions they estimated there would be, roughly, 27,000,000 wage earners with whom they would be dealing. We have in our group and the credit unions and the farm cooperatives alone, 10,000,000 or 12,000,000 people, all of whom receive nominal amounts. I don't know, probably there is another 15,000,000 to 20,000,000 dividend receivers who receive small or nominal amounts where the withholding probably wouldn't justify the paper work or the bookkeeping involved.

Our suggestion, Mr. Chairman, is that you treat the farm cooperatives, credit unions, and our institutions on the same basis that the draft treats mutual savings banks and commercial banks. We are only different in the respect of paying dividends instead of interest in most of our institutions. We technically call our return a dividend. Not a dividend in the sense that a typical commercial corporation pays dividends. It is more a dividend in the sense that a mutual savings bank or a commodity cooperative distributes its earnings, whatever they are.

The CHAIRMAN. It seems to me that the Treasury should note particularly that we certainly should combine the two and say they should be treated on the same basis.

Mr. BODFISH. That is right.

The CHAIRMAN. Where the dividend did not exceed some worthwhile amount.

Mr. BODFISH. There is a little precedent there. Probably Senator Brown could be helpful. At the present time we are required to make special returns on Form 1099 on any amounts of dividends in excess of $100. We make very few of them, because we have few

of that size. The banks have to make returns on interest paid in excess, I think, of $800 at the present time, so there has been some precedent for dealing with institutions who distribute earnings on the basis of amounts, and I assure you that anything that is reasonable and fair is entirely agreeable to us. However, we would like to be on exactly the same basis as the mutual savings banks and the savings departments of commercial banks with regard to withholding, because, after all, that is where the impact of competition for small savings and investments touches us.

Senator BROWN. In legislation setting up your organization, we look upon your dividends as interest?

Mr. BODFISH. To the person that receives them, they are interest in the broad sense that it is a return on their savings or capital.

Senator BROWN. In the same way in which the deposit in the bank and the interest thereon are carried?

Mr. BODFISH. The bank makes a contract to pay 1½ or 2 percent and we say we will take your money and employ it in a certain way and after we have paid our expenses and our losses or reserves for losses, then we will distribute the balance.

Senator BROWN. Are you satisfied with the language that you have on page 3 of your prepared statement? Do you think that covers it?

Mr. BODFISH. We are sure that covers it and that the amendment will take care of the credit unions also. There are some of the State chartered credit unions, Senator Brown, that happen to pay interest. They call their "distribution of earnings" interest.

Senator BROWN. You say interest?

Mr. BODFISH. That is why we say dividends or interest.

Senator BROWN. Dividends or interest?

Senator DANAHER. That wouldn't go at the point you indicate, though, would it, Mr. Bodfish? Do you have a copy of the bill there?

Mr. BODFISH. I have the bill here; yes.

Senator DANAHER. 160.

Mr. BODFISH. Page 160.

Senator DANAHER. Yes. Are you going to put that in line 24?

Mr. BODFISH. Yes; you see there is a definition of dividends in terms of an exemption.

Senator DANAHER. Yes.

Mr. BODFISH. And the only dividends exempted are dividends paid by a foreign corporation which is not engaged in trade or business in the United States.

Senator DANAHER. It seems so wholly unrelated that it has a section, just as you say.

Mr. BODFISH. I wouldn't defend it as ideal draftsmanship but it seemed to be the best place to amend on dividends. I might say, Mr. Chairman, that we have consulted with some of the representatives of the farm credit organizations, and while I cannot speak for them, they are of the view that it affects their dividends on their capital structure, and possibly their patronage dividends.

You see this dividend affects just every kind of dividend. I am not sure about what it might even touch the dividends of mutual insurance companies, but I don't know about that.

The CHAIRMAN. Well, there might be some difficulty in treating you as some other type of institution, but there certainly ought to be some relief on the broad ground that these are nominal amounts and the burden is too great to justify that on organizations of which you have spoken.

Mr. BODFISH. We estimated it would cost us $2,000,000 or $3,000,000 just in our own institutions, and the withholding would not be substantial in amount.

Senator CLARK. The burden on these cooperatives is entirely out of proportion to the revenue produced for the Government by that.

Mr. BODFISH. That is right.

Senator CLARK. I think your point is well taken.

Mr. BODFISH. I think it is a question of establishing a proper minimum as you have done on wages and treating our savings and loan associations and credit unions as you have our banking competitors.

Might I submit for the record this statement which embodies the proposed amendment?

The CHAIRMAN. Yes. Thank you very much.

(The statement submitted by Mr. Bodfish is as follows:)

AUGUST 3, 1942.

In re H. R. 7378, specifically, section 153, page 158, inserting supplement U and sections 425, 426, etc., "Collection of tax at source on dividends, bond interest, and wages."

To: Hon. Walter F. George, chairman, Committee on Finance, United States Senate.

From: The United States Savings and Loan League, Chicago, Ill.; Morton Bodfish, executive vice president; Horace Russell, general counsel.

This statement and request for an amendment is made on behalf of more than 7,500 savings and loan associations, building and loan associations, and cooperative banks located throughout the United States. These associations are cooperative, membership, and special-purpose institutions engaged in encouraging thrift and savings and in the financing of home ownership. We have more than 6,500,000 members who would be affected by the withholding provisions of the pending revenue bill. These members receive two or four dividends a year and under the requirements of H. R. 7378, the withholding of $1.25 per annum per member would be involved in 1943 and $2.50 per member per annum in 1944.

We are joined in our request by the Credit Union National Association, Inc., which represents over 10,000 credit unions with about 4,000,000 members. Credit union members receive dividends as do members of savings and loan associations and the holdings of individual members are so small that the 1943 amount would be about 15 cents per member and the 1944 amount 30 cents per member. We are advised also that there are many farm cooperatives whose members receive small dividends and, therefore, they appear to be in a similar situation.

Our first objection to the withholding requirement is that it is unfair and discriminates against our thrift and savings institutions. The bill does not require commercial banks or mutual savings banks to withhold upon interest paid to their savings and time depositors. There are about 35,000,000 such accounts and depositors in banks. Under the bill, banks do not have to withhold or collect at source upon interest on savings accounts, but savings and loan associations, cooperative banks, credit unions, and many farm cooperatives would have to withhold upon savings accounts and investments. This discrimination or different treatment will adversely affect our institutions and savings and investment members will not understand and will resent our savings and loan associations withholding or collecting at the source when their banks do not.

Our second objection is to the expense and trouble involved from the standpoint of the associations, their members, and the Government compared to the benefits which accrue to the Government from this particular withholding or collection at source. We believe that the withholding of so many small amounts will be a costly nuisance provision involving an almost hopeless and burdensome amount of bookkeeping and correspondence in relation to the small sums thus

prepaid to the Government. Under the present language, savings and loan associations, cooperative banks, credit unions, and farm cooperatives will have to write a letter or communicate with each and every member with a certificate as provided in section 425 (e), then the member will have to return this certificate if he is not subject to Federal taxation. The institution will have to withhold upon all other members and furnish them by mail or otherwise with receipts for the amounts withheld. These small sums will have to be paid over to the Government and the Government will have to open millions of accounts because of them. Many of these parties will not be finally subject to tax and refunds will be involved in addition to the fact that advance collections from this source will be small. We estimate that the cost of postage, letters, printing, and work involved to our own institutions would total $2,000,000 to $3,000,000 per annum. Add to this the cost to the Government of carrying such small accounts and doing all the work attendant in connection with them, it seems that the total amount withheld and paid over to the Government may not greatly exceed the total costs involved.

We do not consider the procedure for securing certificates provided in section 426 (e) nor advance collection of nominal items practical. In fact, thousands of credit unions and savings and loan associations affected do not have the facilities for securing certificates or for handling the small withholding items. We ask relief from the burden of collecting and accounting for small amounts of tax which will also reduce the Government's administrative burden and the cost of collection entailed in handling millions of returns involving only nominal amounts. H. R. 7378 accepts this principle and procedure with regard to wages and bank interest and we believe it should be likewise applied to the earnings disbursed by our institutions.

The discrimination against our savings and loan associations, credit unions, and like organizations which pay dividends can be corrected by adding to section 153, page 160, "section 425 (e)," the following:

"nor shall withholding be required upon dividends or interest paid by credit unions, savings and loan associations, building and loan associations, cooperative banks, and farm cooperatives."

We recognize the many difficult matters with which the Committee on Finance and its technical staff deal. We respectfully request the above amendment to eliminate discrimination and to avoid substantial burdens on these cooperative and membership organizations which pay small dividends to individuals, particularly in vew of the fact that substantial net revenue is not involved in our judgment. Again, nominal amounts have been excepted with regard to wages and bank interest and we only seek comparable treatment.

The CHAIRMAN. I believe that finishes the work for today.

We will recess until 10 o'clock tomorrow.

(Whereupon, at 4:35 p. m., the committee recessed, to reconvene at 10 a. m., Thursday, August 6, 1942.)

REVENUE ACT OF 1942

THURSDAY, AUGUST 6, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order.

Senator BROWN. Mr. Chairman, I would like to have the record show that I am submitting a letter of the Jury-Rowe Co. of Lansing, Mich., to the Treasury, presenting to the Treasury the problem of sales on installments where payments have been accelerated by certain regulations of the Federal Reserve Board with respect to credit, which gives these merchants larger payments than they anticipated in a particular calendar year, and which materially affects their cash receipts and their income. It does seem there is something to the problem, and I am asking the Treasury to work that out.

The CHAIRMAN. Yes. That matter has been brought to my attention, Senator Brown. I am not sure that I have not already mentioned it to Mr. Stam or somebody else. I think something has been under consideration. You are submitting it?

Senator BROWN. I have submitted that letter to the Treasury.

The CHAIRMAN. Mr. Fernald.

STATEMENT OF HENRY B. FERNALD, MONTCLAIR, N. J., CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr. FERNALD. Mr. Chairman and members of the committee, the first and foremost problem confronting us is winning this war. The winning of the war can no more be taken for granted by us than it could be by France. If we lose sight of our fundamental objective and fail to do what needs to be done to win the war, we should not expect to win it. If we do what is needed to meet this main objective, then we may well and rightly consider other, but secondary objectives.

The primary test of any provision of this tax bill is whether it will help or hurt in attaining that main objective of winning the war. We cannot say that whatever will bring money into the Treasury is desirable. Money itself is a dead thing. It is only of value as used to accomplish the desired purpose. Money can be made an instrument for production, but only by putting it to effective use. Production for war needs is more important than the gratification of seeing great sums passing in and out of the Treasury. Money diverted from needed productive effort may hurt and not help the war effort. If we have firmly in mind that the main objective of this tax bill is to con-

tribute best to winning the war we shall recognize that the tax bill must be a means of stimulating, and not obstructing or discouraging, needed production for the war.

The first and foremost objective need not conflict with other important but secondary objectives. We want to raise revenues to pay for this war. We shall not raise this year enough to pay for this year's expenditures, nor do we expect to do this next year or in the following years of what may be a long war. If this year we took the entire $17,000,000,000 estimated taxable net income of all corporations, and the entire $8,000,000,000 estimated net incomes of individuals in excess of $5,000 per year, this would pay only a minor part of this year's expenditures, but would cripple our revenue sources and our productive capacity for future years of the war and for the years after the war. We cannot win the war on the productive effort of a single year, but must maintain needed productive capacity for each year of the war. We cannot pay for the war out of the revenues of a single year, but only out of sustained revenues year after year of the war and of the post-war period.

Our democratic system of private initiatives has developed the greatest productive capacity the world has ever known. That system must be our reliance for production and for Government revenue. If we kill incentive for production we kill our revenues. If taxes, because of the rates at which or the manner in which they are imposed, pass the point of productivity, both revenues and production suffer. We need a strong, active, efficient industry both for production and for revenues. The raising of maximum revenues does not conflict with maximum production, but excessive taxation can hurt both production and revenues.

Furthermore, our need for a sound, vigorous industrial system to give needed production, employment and revenues after the war does not conflict with the purpose of obtaining maximum needed production and revenues over the years of a long war. Where we must choose between present war needs and what we would like to see for the future, our immediate war needs must come first, but in looking primarily at the needs of today we must not recklessly disregard the needs of the future. We must not come to the end of one or two years of the war and then find our war effort dead. I shall later speak very directly of this with regard to the mining situation.

It is from the foregoing standpoint that I shall speak of certain features of the tax bill as they affect the mining industry. I speak of only a few major points, but I urge that in your entire review of this bill you keep in your minds these fundamental tests of each of its provisions:

Will this help or hurt the war-production effort?

Will the amount of present revenue it would yield compensate for any detriment it may be to future production and future revenues?

Will this provision actually yield increased revenue over a period of years, or does it represent a tax imposed at such rates or in such manner that it will reduce or defeat the net revenue yield?

In the recent hearings of the Senate Silver Committee, presided over by Senator McCarran, in Nevada, Utah, and Colorado, the representatives of the mining industry of those States and the neighboring States, such as Montana, Idaho, Oregon, California, Arizona, and

New Mexico, discussed the effect of taxation upon their operations. I attended these hearings and listened to the presentations made. I cannot forecast the report the committee will make with regard to them, but I state by own conclusions, concurred in by the tax committee of the American Mining Congress.

There was general agreement among mining men that taxation was obstructing production—particularly where additional financing was needed. To indicate why this is so, I set forth certain typical situations:

Effect of taxes on mine production.—(1) Mines now developed and operating with adequate finances, efficient personnel, and abundant ore reserves may be able to continue and even expand operations. To maintain production, development work must be kept ahead of production, and equipment and facilities maintained and replaced as needed. To increase production, there must be extension of development work and probably enlarged facilities. Substantial working capital is needed to carry costs between the time of first expenditures and the final receipts for the product, as well as to meet the special expenditures which may be needed for additional developmnt work and enlarged facilities—perhaps far beyond normal requirements. Needed facilities may include those for treatment and transportation of the product of the mines as well as those for getting the mineral out of the ground. Problems must be met and solved, including all the natural difficulties which at any time exist, and the emergency problems of wartime shortages of manpower and materials, innumerable and often conflicting regulations and requirements of Government departments and all the uncertainties of what may lie ahead. Mining men have been, are, and will continue endeavoring to do all in their power to meet these as a challenge and make available the buried metals needed for the war.

The well-developed, equipped, and financed mining company can and will make the utmost production it can, whether or not it likes the kind and amount of taxes imposed. However, taxes are peculiarly within the direction and control of the Government, and the Government has a special responsibility to see that taxes do not serve as penalties unjustly inflicted upon those trying best to meet the Government demands. Unfair taxation, like any other unfairness by the Government, tends inevitably to discourage the spirit of accomplishment needed to get maximum production. It is sound business and sound government to have such tax laws as will encourage, and not discourage, production which the Government desires. Mining men will not in this emergency consciously curtail or limit production of the mines because of adverse tax laws, but it is hard for anyone to do his best unless he can feel the Government intends to deal fairly and justly with those trying to meet its requirements.

(2) Some operating mines do not have their own funds adequate to expand operations. To do this they need additional finances. If profits from any increased production will be treated as excess profits and subjected to a 90-percent tax, there is no sound basis for seeking investment of new money. Those with moneys already invested in a mining property may have the duty to see that the

property is operated to yield maximum production, but there is no such compulsion on other investors to put new money into a mining property if tax laws offer no prospect of a reasonable return. No corporate management can conscientiously urge investment of new money subject to the risks of the business, with little, if any, prospect of recovery of capital and a return commensurate with the risk. The management in its trustee position is not warranted in sacrificing existing equities of present stockholders to obtain new moneys as investments or as loans. If 90 percent of any additional profits will be taken in tax and borrowed money will outrank present investment, the new money borrowed, whether from the Government or private investors, inevitably sacrifices the equities of present stockholders.

It is true that in some cases the Government might help overcome its own tax obstruction by itself providing movable equipment or plants so located that the Government's ownership or lien thereon will not imperil the present interests in the property. If, however, buildings or equipment must be so located that the Government's interest therein constitutes a lien on existing facilities or upon the mine itself, this will mean the sacrificing or imperiling of present equities. Clearly, there is a difficult situation if taxes prevent reasonable private financing and require the impairment of present equities as a price of getting Government assistance.

The remedy here is to provide adequate allowance for reasonable profits on increased production and a reasonable return on new investment so that existing equities will not have to be impaired.

(3) Now known mines which need to be newly developed and equipped or redeveloped and reequipped present a financing problem even more serious. Taxes at high rates cannot be ignored by prospective investors. They must look at the net return after the Government has taken the taxes it imposes. To see the seriousness of this situation, we may note that if the corporation earns 10 percent on its capital (new money) exempt from excess-profits tax but subject to a 45-percent income tax, this leaves the corporation net only 5½ percent. A stockholder subject to a 33-percent income tax, which point is reached at $10,000 of income, who receives this 5½ percent will have a net return of only about 3½ percent on his investment—wholly inadequate to cover the risks involved. If, however, the earnings on new money are subject to a 90-percent tax, there can be no hope of new investment.

(4) The problem of exploration and development to find and open up new mines is still further imperiled. There can be little incentive for the prospector to go ahead in his search for new mines or preliminary development of them if he must feel that when he has discovered a prospect and proven the possibility of a productive mine there is little hope for financing it under existing tax laws.

Thus, the tax laws have their very definite bearing in obtaining needed production of war materials.

I have given this brief and incomplete outline to illustrate how certain tax features, later referred to, have their important bearing on production of war materials.

With these points in mind, I shall speak of certain particular features of our tax laws.

I. DEPLETION

It is essential that proper depletion allowances be made. I shall not speak at length on this because it will be a subject of special presentation to your committee by others, but we urge that the provisions of the House bill as they are before you be continued. These fairly and rightly meet the general needs of the mining industry. There are certain special situations of which I shall later speak.

II. UNIT OF PRODUCTION CREDIT FOR EXCESS-PROFITS TAX

Under present law, mines, as other industries, are entitled to a specified credit based on invested capital or on income for the years 1936 to 1939. Any income in excess of such credit is subjected to the excess-profits tax, which under this bill is 90 percent. The war authorities have been and are urging mines to increase their production of essential metals and minerals for the prosecution of the war. Many mines have done so. Others are endeavoring to do so. But the excess-profits tax may heavily penalize those responding to the Government's demand.

Mines differ from ordinary industry. The merchant or manufacturer who increases his output this year will do so by increasing his purchases of raw materials, but this does not limit or curtail his ability to purchase such raw materials in future years. Mines can only increase their production by using up their capital assets, so that what they produce this year curtails their ability for future production. The mine does not really have excess profits unless it obtains more than a normal profit per unit of production.

Under present law, assume a mine had produced an average of 100,000 tons of ore a year in the base period at an average profit of $1 a ton, and had an excess profits credit of $100,000. If during the taxable year it again produced 100,000 tons of ore but at a profit of $1.50 per ton, or $150,000, the additional $50,000—being more than the normal profit—would be treated as excess profits. To this we take no exception. However, if what happened was that this mine increased its production to, say, 150,000 tons, still making only the normal profit of $1 a ton or a total of $150,000, under the present law this normal profit of $50,000 on the increased tonnage would be treated as if it were excess profits and subjected to the 90-percent tax. If the company should produce the 150,000 tons at a profit of $1.50 a ton, or a total of $225,000, there is no protest against treating the additional 50 cents a ton, or $75,000, as excess profits. What the mines are protesting is the treatment of the normal profit per ton, or per pound or other appropriate unit, as if it were excess profits and subject to the heavy tax. It is a tremendous sacrifice that the present law requires mines to make for giving their cooperation to the war effort. Mines have done and mines will continue to do their utmost to increase production, but they ask that the tax law deal fairly with them and not penalize them for the cooperation which they give.

This is the situation which the amendment of Senator Johnson of Colorado, offered last year (Congressional Record, September 4, 1941, p. 7483), was intended to correct. Copy of this is submitted as exhibit A, but including certain further provisions to which I later refer.

(Exhibit A submitted by Mr. Fernald is as follows:)

EXHIBIT A

AMENDMENT PROPOSED BY SENATOR JOHNSON OF COLORADO TO SECTION 713 OF THE INTERNAL REVENUE CODE, WITH CERTAIN ADDITIONS NOW PROPOSED TO ITS WORDING, SUBMITTED BY MR. FERNALD

[Additions indicated by italics]

"(h) Corporations engaged in mining—

"(1) A corporation engaged in the mining of natural deposits shall be entitled under this section (with respect to its mining operations) to an excess-profits credit equal to the normal profit per unit of production for its entire production during the taxable year, in addition to such other excess-profits credit as may be allowable under this subchapter which is properly allocable to its operations other than mining.

"(A) In the event that the taxpayer was actually in existence at the beginning of its base period and was, during all or a part of such base period, engaged, on a commercially profitable basis, in mining operations similar, except as to the volume of production, to those carried on during the taxable year, then the taxpayer's normal profit per unit of production during the base period (excluding the year or years in which there was a deficit in excess-profits net income) shall constitute the taxpayer's normal profit per unit of production for the purposes of this subsection. In computing such normal profit per unit, the adjustments provided by section 711 (b), so far as applicable, shall be made.

"(B) If the taxpayer was not in existence at the beginning of its base period, or if it was not, during all or a part of such base period, engaged, on a commercially profitable basis, in mining operations similar, except as to volume of production, to those carried on during the taxable year, *or if the taxpayer during all or part of such base period was not selling its product on the open market on a competitive basis and the price received for its product was not representative of fair market prices for such period*, then the normal profit per unit of production shall consist of the base period profit per unit of production which the taxpayer would have realized if it had been so engaged during such base period *or had sold its product at market prices*. Such normal profit per unit shall be computed by assuming that the taxpayer had sold in each year of the base period the number of units which it could have produced and sold, with due regard to the average prices and costs of operation prevailing in each base period year, except that the number of units assumed in such computation for any base period year shall not exceed the number of units sold in the taxable year; *but in no event shall the normal profit per unit thus determined be less than such amount of profit per unit as would normally warrant the development and operation of a mine such as that for which the allowance is made.*

"(2) The term 'base period' means, for the purposes of this subsection, the base period as elsewhere defined in this subchapter, but if the base period of a taxpayer is not elsewhere so defined, in such case the term 'base period' means the calendar years 1936 to 1939, inclusive.

"(3) This subsection shall not apply if the excess-profits credit computed under section 713, without the application of this section, or under section 714, exceeds the amount of the credit computed under this subsection."

MR. FERNALD. Consideration of the amendment was then deferred until the administrative bill which it was contemplated would follow shortly. The subject has been discussed at some length with Treasury representatives. The problem involved is well set forth in the House committee report, page 149, as follows:

> The War Production Board and the Office of Price Administration are endeavoring to stimulate the production of certain metals by offering premium prices, in excess of the ceiling price, for production in excess of specified established quotas. Thus, for the same total output over a period of years, the total amount of taxable excess profits will be greater if the output is concentrated in a few years than if it is spread over a longer period, since the aggregate excess-profits tax credit for the period depends upon the number of years included therein. This problem does not appear in industries which do not have depletable resources since future production is not thereby reduced.

The only change made by the House bill to meet this situation is the amendment of section 711 (a) by section 213 (p. 217) of the bill which would exclude, from excess-profits net income, bonus payments made for production in excess of a specified quota. We agree that such bonus payments are properly to be excluded from excess-profits net income, but this does not meet the problem. Companies, which to meet the demands had already increased production by 1941, could not get allowances for this under the quota system. Moreover, only certain particular metals—copper, lead, and zinc—have such quota allotments. The remedy should be much broader, along the lines of the Johnson amendment.

The Johnson amendment would give the benefit of the unit of production credit in the following manner: To companies which had an appropriate operating experience in the base period the normal profit per unit would be determined on the basis of that experience. For mines which did not have such an appropriate operating experience, a constructive determination of normal operating profits would be made. In this latter class would be newly formed corporations or newly opened mines; mines which did not have a commercially profitable operating experience in the base period which would be fairly representative of normal profits, and so forth. The determination of what constitutes a reasonable normal profit allowance per unit would be made by the Commissioner.

A further situation which was not covered by the Johnson amendment as drafted last year, but which should be covered, is with respect to those mines which could not have operated profitably during the base period. At that time the need for some of these strategic and critical minerals had not become so great as it has since been recognized to be. Even though such mines could not have been operated at a profit under base-period conditions, there is nevertheless some minimum normal profit which in any case should be recognized as necessary to warrant the opening and operation of any mine. The law should recognize this.

Another situation which should also be recognized is where there has been some essential change in the organization and method of conducting business between the base period and the current year. Here also the determination should be made of what would represent the normal unit of profit under present methods of organization and business conduct.

The need for an amendment such as proposed by Senator Johnson has been recognized and we urge that it be included in this bill.

III. STRATEGIC AND CRITICAL MINERALS

The 1940 act granted excess-profits exemption to production of certain strategic metals there listed. This exemption was repealed by the 1941 act even though many persons had gone ahead with exploration and development relying upon the exemption granted. The exemption should be restored.

There is also a further situation with regard to such strategic metals and other minerals for which we have great need in our war effort. Many of these metals could not have been produced in this country before the war in competition with foreign supplies which were available from rich deposits, produced with cheaper labor, and

available at low prices. These metals we need desperately today, but we must recognize that after the war it may no longer be profitable to produce them here in competition with the foreign supplies which presumably will again be available. You see, I am speaking of a very special situation which is very serious. There are also many marginal or submarginal mines, of these and other minerals, from which we are trying to get further production at the present time even though it is doubtful if such mines can operate profitably in normal times. Such mines do not warrant investment on a long-term normal basis; yet the Government may apply to them its usual rules for depreciation, depletion, and recovery of development costs. Under these rules the Government may treat as income what may really be a return of capital, and may take so much in income and profits taxes that investors will never realize a return of their capital. For such mines, with uncertainty of operating life, which probably could not have been operated at a profit in the base period and which can hardly be expected to operate at a profit in the post-war years, there should be made a special rule which would permit them to recover their capital before there is any computation of taxable profit.

Senator VANDENBERG. Is it possible to identify them?

Mr. FERNALD. We will have to do that under some properly framed and broad discretion.

Senator VANDENBERG. Delegating the power to the Commissioner, or something of that sort.

Mr. FERNALD. Something will have to be worked out, Senator; I know it is hard, but I think it is a problem that can be solved if the situation is once recognized. We simply want a fair rule. We do not want this to be applied to those mines which undoubtedly are going to have a long life. They stand on a different basis. It is the temporary mines that we are concerned with. I have not tried to submit it here, sir, because I felt it was better to get the recognition of the situation. We will be very glad to discuss it with the Treasury and see how we could formulate a proper rule.

Senator VANDENBERG. Are there a good many of them?

Mr. FERNALD. There are a great many of them, sir, throughout the West. That applies to these special minerals, and there are also a good many marginal mines that we are trying to get opened up because we need that production.

Such an allowance should be obtainable under present law if the taxpayer could present convincing proof to the Commissioner that there was no possibility of recovering more than the investment, but this is difficult or impossible to prove. There is a wide difference between the proof which might satisfy the Bureau, and the estimate of probabilities which would determine the action of a prospective investor. The investor can hardly be expected to put his money into the property if the Government may take a large part of all realizations during the emergency, leaving the investor to recover his investment out of possible, but little expected, realizations of the future. The fair rule in such cases seems to be clearly that the investor should be permitted to recover his investment before the Government treats any of the proceeds as profits subject to either income or excess-profits taxes.

We urge that such a provision as this be included in the law to meet

the situations that have developed and are developing in the search for war-essential metals and minerals.

IV. TAX ON FREIGHT

The proposed 5 percent tax on freight would apply with particular severity to the mining industry which now has maximum prices fixed for its products. Freight charges on incoming materials and supplies as well as on outgoing product generally form a heavy item of mining cost. These would be increased by the tax on freight which could not be passed on to the consumer. In many cases this will involve tax on the crude ore to the mill, on concentrates to the smelter, and on metal to the refinery and even possibly on refined products to the market. All of these would have to be borne by the mine operator as against the fixed price for his product. Isolated mines would be penalized because of their location and the industry as a whole would be saddled with a burden which would definitely act to reduce production. We join with the Secretary of the Treasury in opposing this as an undesirable tax.

V. DEDUCTION OF TAX AT SOURCE

The bill devotes pages 159 to 181, inclusive, to "Supplement U—Collection of tax at source on dividends, bond interest, and wages." The plan there proposed for collections with differential allowances for personal exemptions and dependents will impose a tremendous burden on employers. It will be an extremely heavy load for the many small mines of the country, already suffering from a shortage of clerical labor and burdened with the great volume of additional reports which the Government is now requiring. We urge that any system for collection of taxes at the source should be a flat percentage of the amount paid. The burden of this would be substantial but nothing like that required to make all the differential computations under the complicated provisions of this bill.

VI. BASIS AND RATES UNDER THE PROPOSED BILL

(*a*) *Rates of tax.*—The proposed rates of 45 percent normal and surtax and 90 percent excess-profits tax are exceedingly high. We have already pointed out that with such rates there should be scrupulous care to see that the excess-profits tax is not imposed on anything which is not truly excess profits and that the normal tax is not imposed on anything which is not truly income. Even so, we feel that at such high tax rates industry cannot survive and prosper to discharge its functions of efficient production during and after the war.

We believe the normal tax should not exceed 33⅓ percent, having in mind particularly that profits distributed to the stockholders are again subject to tax.

The excess-profits tax, we believe, should not exceed 80 percent and the rate schedule should be stated by brackets based on percentages of the excess-profits credit. Even at best it will be impossible to mark out fairly a clear dividing line between normal and excess profits and there should be at least one or two fairly broad brackets, starting perhaps at 50 percent and reaching a maximum of 80 percent.

(*b*) *Invested capital credit.*—The present law allows a credit of 8 percent on the first $5,000,000 of invested capital and 7 percent on additional amounts. The pending bill reduces the credit on invested capital over $10,000,000 to 6 percent and 5 percent. The Treasury Department is on record as recognizing that 8 percent is probably the minimum rate at which we could generally expect business investments would be made. We should return to the flat 8 percent credit of the 1940 act; or at least continue the 8 percent and 7 percent allowances of the present law.

(*c*) *Income credit.*—The years 1936–39 were not years of normal profits. Generally, there was at least one very poor year without an offsetting high profit year or years. We again urge, as we have urged before, that the taxpayer be permitted to have his base period credit based on the average earnings of 3 out of the 4 years, determining that average by dividing by three.

(*d*) *The excess-profits tax should be imposed on the average profits of the war period.*—Excess profits are not to be determined solely on the basis of the earnings of a single year. The net operating loss carry-over and the excess-profits credit carry-over should be extended to at least 5 years, or the period of the war, and there should be provision for a credit backward from later to earlier years, all worked out so that the tax will be on the average profits for the war period and not on profits of a single year which may be largely or wholly offset by losses or low profits of other years.

(*e*) *Provision for savings.*—We urge that provision be made for a savings plan allowing deductions up to 20 percent of taxable income for investments made by the taxpayer in Government bonds. The Government would thus receive funds it now needs and the corporation would be placed in a position to have needed funds to meet the post-war requirements. I wish I could speak more at length on that.

(*f*) Capital stock and declared value excess-profits tax should be repealed.

(*g*) Consolidated returns should be permitted for income as well as excess-profits tax as provided in the bill; but there should be no differential in tax rates. Consolidated returns should also be allowed for capital-stock tax and the related declared value excess-profits tax, if these are continued as provided in the bill.

VII. TECHNICAL AMENDMENTS

(*a*) *As to invested capital.*—(1) The amendment made by section 212 of the bill to section 718 (a) (2)—as to the adjustment to be made where the unadjusted basis of the property is a substituted basis—is eminently appropriate. Similar provision should be made under section 720 with respect to adjustments for inadmissibles. Perhaps this is understood but it should be expressed to avoid question. These should be with retroactive effect.

(2) The taxpayer should not be denied the cost basis for property as invested capital merely because the property was acquired in some particular form of exchange or reorganization when there was no thought of consideration of a possible future invested capital determination. At least, there should be a general relief provision ap-

plicable where there is a substantial discrepancy between tax basis and cost.

(3) The basis for computing gain rather than basis for computing loss should be used for property under section 718 and section 720.

(4) Daily computations should not be required; or the Commissioner should be given broad authority to waive the requirement. I beg you do not brush that lightly aside.

(5) Borrowed capital should be fully included in invested capital.

(*b*) *Special relief.*—We recognize the endeavor made in the bill to grant relief to meritorious situations. However, much of the value of these provisions seems in danger of being canceled by the last sentence of section 722 (a) which would disregard "events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939." We urge this sentence be omitted from the law.

There should be no penalty tax when special relief is granted. Full allowance of relief where found appropriate should be given without the limitations and additions of section 722 (e).

(*c*) Section 734 regarding inconsistencies should be repealed, or at least substantially amended, so it will not be the unjust and oppressive provision which now exists. Such repeal or amendment should be with retroactive effect.

(*d*) The amortization provisions of section 124 should provide allowance for necessary facilities which may not have been completed at the termination of the emergency.

(*e*) Interest on deficiencies should be at a rate not to exceed 8 percent.

Senator BROWN. Likewise, would you provide the same rate for refunds?

Mr. FERNALD. Yes, sir.

Senator BROWN. I agree with you on that.

Mr. FERNALD. (*f*) The fiscal-year provisions of the pending bill should be changed to adhere to the same principle as in all our recent acts; so that the new rates would apply only to the fiscal years beginning after January 1, 1942; thus avoiding the double computations required under the bill.

The CHAIRMAN. Are many of the mining companies on a fiscal-year basis?

Mr. FERNALD. There are a substantial number, sir. Some of them have done that on account of the winter season, which makes it very difficult for them to take their inventories and make their final check-up. Just as a natural thing they have taken a fiscal year other than December 31, which for them is the worst time of the year to close. The majority of mines are probably on the calendar-year basis.

Senator BARKLEY. After the first year, even if it should be left as it is, does it make any difference? It is just this first year that they will have to go back.

Mr. FERNALD. If they could change their fiscal year to a calendar year it could be worked out, but if they are under these difficult situations they ought not be compelled to change against all the natural situations that enter into it.

Senator BARKLEY. That might be, but if they do not change would this difficulty you speak of only occur in the first taxable year? There

never ought to be, and I do not suppose would be, any period in which there would be a duplication of months in which they paid a tax for 2 different years.

Mr. FERNALD. If the year is arranged from June 30 to June 30, or May 31, you see, each year they are going to have part in one and part in another. Of course, if this bill is to continue unchanged for 5 years what you say would be true, but our prior record does not indicate that probability.

Senator BARKLEY. I would like to think we would not have to pass another tax bill for 5 years.

Mr. FERNALD. So would I. I would like to see this bill so worked out that we could sit back and say this is the best that can be devised.

(*g*) Recomputation of credit carry-over should not be required. It is burdensome enough to make once the computations involved, particularly where invested capital applies. Where the amount has once been computed and determined it should not be necessary that it be recomputed again to cover each change which may be made in subsequent law.

(*h*) The capital gain and loss provisions as to corporations included in this bill we believe are unfair and the provisions of the present law should be continued.

VIII. RENEGOTIATION OF CONTRACTS

Legislation recently enacted makes provisions for renegotiation of Government contracts. We do not know exactly what may be required under these laws nor just how they will be applied, but it seems to us that the legislation virtually ignores or conflicts with the principles of the excess-profits tax. The purpose of the excess-profits tax is to impose this very heavy tax on profits which are excessive. The provisions for renegotiations of contracts seem intended to require readjustment of contracts where these are yielding more than a reasonable amount of profits. This conflict and confusion leaves operators in a state of uncertainty as to where they may stand between these two laws, with little opportunity for intelligent planning of their operations, commitments, or finances.

For the products of the mining industry generally prices are fixed at levels aimed to bring out needed production. Earnings from Government contracts are on the basis of prices thus fixed. We believe the existing confusion and uncertainty should be terminated by repeal of the requirements for renegotiation of contracts, at least so far as mines are concerned, leaving a properly formulated excess-profits tax imposed on excess profits if they exist.

We believe a sincere effort has been made in drafting this bill to have it fair and equitable. The rates are exceedly high—we believe too high—but the higher the rates the more important it is that the tax bill should not be a crushing burden on industry. We appreciate the expressions repeatedly made by the chairman of this committee and the chairman of the House Ways and Means Committee, to the effect that taxation must not be a crushing burden on industry which would leave it prostrate and unable to function after the emergency. We have supplemented that by urging it must also be a tax bill under which industry can function with maximum efficiency during a long war. We have further added that these standards do

not conflict with the standard of maximum revenue. In the long run the industry which can give maximum production over a long war will form the basis for maximum revenues, both from industry itself and from those who derive their incomes from industry. This is the only firm foundation for Government revenues.

Accordingly, we believe that the provisions we are urging will not mean any sacrifice of revenues but will mean both increased production for war needs and post-war needs, and increased revenues to the Government.

The CHAIRMAN. Thank you very much, Mr. Fernald. Are there any questions, gentlemen?

Senator VANDENBERG. On the question of the renegotiation of contracts to which the witness referred, I think it might be helpful to observe that I have received a letter this morning from Mr. Paul on this subject, which indicates that the War Department, the Navy Department, and the Treasury are seeking, by mutual agreement, to arrive at a system under which when renegotiation reduces income which has been previously taxed, that the tax thus paid shall be a credit against the reduction and renegotiation. So that the issue which we confront at this particular point is whether you dare rely upon interdepartmental agreements or whether you would rather have a little something in the law.

Mr. FERNALD. Undoubtedly, it would be far better to have that in the law and not have them disagreeing, as they are at present, where nobody knows where he does stand on it. Just think of the situation where you have this proposition of renegotiation hanging over you for years and years, so you never know what that situation is, when you may be under attack as to the past matters. What we are saying is this: You fix prices for the mining products generally at your maximum prices, prices that are supposed to be fair. Those are the bases of our sales under Government contracts. Haven't we got all the fair standard that we need in that way? I think we have, and I think we can simplfy the thing greatly.

The CHAIRMAN. I think there is a great deal in what you say, and ultimately the Congress will repeal that renegotiation-of-contract provision, because it has been found that it will be utterly unworkable.

Senator TAFT. Mr. Chairman, I think it ought to be repealed in this bill.

The CHAIRMAN. I think in doing that there should be an over-all limitation on profits on war contracts, both prime contracts and subcontracts, over the whole period, so that there could be no unconscionable profiteering out of the war.

Mr. FERNALD. That would be profits after what has already been taken by taxes.

The CHAIRMAN. Yes; an over-all limitation on the war profits directly. I think you can very well leave the excess-profits tax to operate on all nonwar profits anyway.

Mr. FERNALD. I think you have gotten it to operate pretty well on the war profits as well, sir. I am not very much disturbed about that.

The CHAIRMAN. It is not the renegotiation, it is the uncertainty involved, and the long time in which those renegotiations will be going on, and the constant change of personnel at the head of divisions working it out, leads to so many complications until certainly at some

time during this war, if the war goes on for another year or two, we are going to have to deal with that question. It is very proper to say it should be dealt with.

Mr. FERNALD. Thank you, sir.

The CHAIRMAN. Thank you very much, Mr. Fernald.

Mr. Harbaugh.

STATEMENT OF M. D. HARBAUGH, CLEVELAND, OHIO, VICE PRESIDENT AND SECRETARY, LAKE SUPERIOR IRON ORE ASSOCIATION

The CHAIRMAN. Are you from the American Mining Congress also?

Mr. HARBAUGH. Yes. I am really appearing here, however, on behalf of the Lake Superior Iron Ore Association, whose members are also affiliated with the American Mining Congress.

Mr. Chairman and members of the committee: I am M. D. Harbaugh, of Cleveland, Ohio, vice president and secretary of the Lake Superior Iron Ore Association. The membership of this association consists of independent iron-mine operators who produce nearly 60 percent of the total iron ore from the Lake Superior district, which supplies about 85 percent of the iron ore produced in the United States. The vital and indispensable function of iron ore in our present war effort should command your attention to existing Federal tax inequities, which unless corrected may impair seriously the future of this industry in the Lake Superior district and thereby threaten the security of the large and important iron-and-steel industry in the lower Great Lakes region depending on this district for its ore supply.

Because of the wartime demand for their product, the iron mines of the Lake Superior district are facing rapid exhaustion of their reserves of merchantable ores. The average annual shipments of iron ore from Minnesota, Michigan, and Wisconsin, the Lake Superior States, in the base-period years 1936–39, were about 43,000,000 tons, and for the 10 years ending with 1940 were less than 34,000,000 tons. Compared to this, shipments were nearly 81,000,000 tons in 1941 and will probably exceed 91,000,000 tons this year. Beginning with 1943, the requirements are expected to be in excess of 100,000,000 tons per year, to meet the wartime needs for production of iron and steel. If the iron-ore industry of this district is to continue, for any substantial period in the future, to supply most of the ores for the iron-and-steel industry of the United States, it will be necessary to develop processes and plants for concentrating large tonnages of almost unlimited supply of low-grade ores available in the district.

The acuteness of this problem is apparent when it is realized that of the 100,000,000 tons of annual output expected to be supplied from the Lake Superior district, about 80,000,000 tons must come from the open-pit mines, the known reserves of which are now reduced to approximately 500,000,000 tons. Thus the remaining life of these easily mined ores—at the current and expected rates of production for the war period—is but a few years. And while there are substantially larger reserves of underground merchantable ores, production from these cannot be stepped up to an extent at all adequate to replace the open-pit production.

Therefore, it is imperative that this mining industry proceed without delay to make preparations to supply a large part of the future ore requirements of our iron and steel industry with concentrate made from the lean iron-bearing rock of the Lake Superior ranges. No other domestic source is available, and our national security demands that our iron and steel industry never be allowed to become dependent upon foreign sources of ore. Already many operators are vigorously at work on this low-grade ore problem. The undertaking will require tremendous outlays of capital for plant and equipment, far beyond the normal capital expenditures made in exploring and developing the type of ores now being mined.

The present allowances for the return of the mine operator's capital are supposed to supply him with funds to reinvest in exploration and development of additional reserves to carry on his mining enterprise. However, the amounts of depletion allowed or allowable to iron-ore producers under the provisions of the present revenue act, or the proposed act now under consideration, together with allowances for depreciation, are entirely inadequate for operators in this district to replace the production from their rapidly wasting developed ores of commercial grades, with production from the concentration of large tonnages of low-grade ore. This concentrate production can be won only after extensive research and experimentation and by the expenditure of very large sums of money for concentrating plants and equipment. It is estimated that the capital investment necessary to produce 1 ton of concentrate per year from this low-grade ore is at least $10 per ton, which is several times the present capital investment per ton of annual production. It would therefore require an investment by this industry of approximately a billion dollars to produce annually from low-grade ores the tonnage of equivalent concentrate to replace all the present iron-ore production of the Lake Superior district.

For the industry, confronted with this tremendous problem and the great investment required, to be denied equitable treatment under the tax laws, imposes upon it an unwarranted burden at a most inopportune time.

In view of this special situation of the Lake Superior iron-ore industry, it is doubly important that there be established in the tax law a clear-cut definition of excess profits of mines, so that what are really normal profits shall not be taxed at the confiscatory rates applicable to true excess profits.

The owner and operator of an iron mine is in an entirely different situation from that of the owner and operator of a factory or other industrial concern. The ore reserve of an iron mine is a fixed and usually determinable number of tons. When this ore is extracted the mine is exhausted and the operator is out of business, unless he can discover new ore supplies or develop new processes to make available lean and low-grade reserves not previously considered merchantable.

Consider a typical case of a mine with a known reserve of say 900,000 tons, which in normal times is mined at the rate of 100,000 tons per year, at a profit of 50 cents per ton, or an annual profit of $50,000 before Federal taxes. This same mine, in order to produce the ore needed for the war emergency, is stepped up to 300,000 tons annual production, thus becoming exhausted in 3 years. At the end

of this period the producer is out of business so far as this mine is concerned. Under the present tax situation, he would be allowed only one-third the amount of credit against excess-profits tax that he would have been allowed if his operations had continued at the normal rate of output. Merely because he has responded to the demand for all-out production, and has exhausted his mine in 3 years instead of the expected 9 years, he is said to have large excess-profits, even though he makes but the same 50 cents per ton that he was making before the emergency.

Senator BROWN. Mr. Harbaugh, that would be true both under the present law and under this bill.

Mr. HARBAUGH. Yes.

Senator BROWN. The only thing is the high rate is perpetuated.

Mr. HARBAUGH. Yes, indeed.

Senator TAFT. You are asking for the Johnson amendment that the Senate adopted?

Mr. HARBAUGH. Yes; the Johnson amendment with some small modification, as Mr. Fernald referred to, would answer the problem.

Senator TAFT. It really passed the Senate, or was it in conference; or do you remember?

Mr. HARBAUGH. I do not recall where it got stalled.

The CHAIRMAN. I think it went to conference.

Mr. FERNALD. Mr. Chairman, may I just announce about the Johnson amendment. It was presented on the floor of the Senate and deferred with the understanding that it would be taken up with the administration bill which was shortly to follow.

The CHAIRMAN. You are correct, Mr. Fernald. I thought it went to conference.

Mr. HARBAUGH. Thus the bulk of the returns from the accelerated production would be paid to the Government in taxes. In this particular case, applying the rates of the bill now under consideration, the producer would have a total return—after Federal taxes—during the 3-year life of his property of but slightly more than half the return he would have had in its normal 9 years of operation.

Thus this mine owner would exhaust his mine over the short war period and practically commit financial suicide, because most of the return from the stepped-up operation of the property would be taken by the Government in taxes. The situation of an ordinary industrial producer is quite different, because he would still have his plant and access to raw materials with which to continue to produce after the war emergency.

In the above-mentioned example, if the normal profit per unit of production were 50 cents per ton, amounting to $50,000 annually in the pre-war period, then in order to place the mine operator in the same relative position regarding liability for excess-profits tax as the position of industry in general, the mine operator should have a credit for excess-profits tax of 50 cents per ton on his emergency production, or $150,000 per year instead of the $50,000 credit now allowed based on the average annual pre-war income. It would seem axiomatic that profits of mines which are not in excess of the normal profit per ton of output are not excess profits and should not be so taxed.

Senator VANDENBERG. Particularly when that production was at the order and insistance of the United States.

Mr. HARBAUGH. Absolutely. These companies would rather not mine this out so fast, there is no question about that.

The iron mining industry should not be drastically penalized for greatly increasing ore production and prematurely exhausting its ore reserves in order to meet war demands. Unless the above suggestion with reference to excess-profits tax credit is granted to iron ore mines, many of the ore producers will find themselves out of business at the end of the war, their reserves completely exhausted, without sufficient funds and with little incentive to brave the hazards incident to the costly future development of production from the available low-grade iron-bearing rock.

Senator BROWN. Right at that point I would like to have you tell the committee what percentage of this kind of ore in the Lake Superior mines is mined.

Mr. HARBAUGH. If I understand your question, the commercial grades of iron ore at the present time average about 51½ percent iron.

Senator BROWN. It is over 50 percent?

Mr. HARBAUGH. Yes.

Senator BROWN. Your low-bearing ores run around 35 to 38 percent?

Mr. HARBAUGH. They run upward of 30 percent and less than 40 percent. It is necessary to concentrate that material, of which there is an unlimited supply, in order to take the place of these commercial grades of ore which heretofore we have been able to mine by open-pit methods very simply and rapidly. If we had not had these open-pit ores at the present time for this war emergency, I do not know what we would have done, because it is mainly these mines that have been able to account for this very rapid expansion of output.

Senator CONNALLY. They just bring it up with a steam shovel?

Mr. HARBAUGH. It has to be stripped of the very heavy overburden, of course, which is sometimes 100 feet or more, and it is then mined with power shovels.

I might mention to you that the shipments in the month of July by lake were 13,400,000 tons in 1 month. The shipments up to the 1st of August were over 47,000,000 tons from the three States of Minnesota, Michigan, and Wisconsin. That is more than the normal annual movement. As I have shown you the figures before, the average for the 4 years of the base period was 43,000,000 tons.

Senator BARKLEY. Is there any other recoverable quantity in this 50 or 49 percent in the ore of the good mines?

Mr. HARBAUGH. That is waste material. In addition to oxygen with the iron, that is silica and a few other impurities.

Senator BROWN. It seems to me another factor in the situation is if you mine these properties at an abnormal rate your investment in transportation, in ships, is going to have to be increased. Actually, the companies have tremendously increased their investment in transportation facilities, particularly four or five giant ore carriers that are either constructed or under construction.

Mr. HARBAUGH. Yes.

Senator BROWN. Which you will not need when the demand for ore falls off after the war.

Mr. HARBAUGH. That is probably true.

The CHAIRMAN. All right, Mr. Harbaugh.

Mr. HARBAUGH. As to normal taxes, there is no thought on our part that the mine operator should receive any different treatment

than that accorded other industrial concerns; and if a mine earns more per ton than its normal profit, there is no thought on our part that this excess profit per ton should be relieved of the excess-profits tax. For example, in the above-mentioned case, if the producer should make 75 cents per ton on the accelerated production, then the 25 cents per ton in excess of normal profits should be subject to excess-profits tax.

It seems imperative to the welfare of our Nation that the Lake Superior iron-mining industry should come through this war emergency in a financial position which will permit it to carry on its normal functions of producing an essential raw material, thus supporting a large population—not only in the mining district but in the great industrial region tributary to the Great Lakes—and of paying taxes which will be so much needed in future years. Incidentally, it may be mentioned that production of ore from low-grade material will give employment to many times the number of persons heretofore required in this industry—doubtless a matter of extreme importance in the post-war era. These concentrating plants necessarily will employ a large number of men. Unless the ore producers can retain a substantial and reasonable part of their profits to spend in exploration and experimentation and for the necessary plants and equipment for the development of additional ore reserves through the means above referred to, these ends will be largely defeated. In the normal course of events this job of concentrating the low-grade ores would not have to be done for another 15 or 20 years, perhaps. Everybody has looked upon it as the thing which must be done eventually, but in the distant future. Here it is right on our doorstep.

The Treasury Department has recognized the need for special relief for mines from excess-profits tax in order to equalize their situation as compared to other industries. This was expressed to the Ways and Means Committee at its recent hearings on revenue revision, by Mr. Randolph Paul, special adviser to the Secretary of the Treasury, in his appearance on April 16, 1942, when he stated:

> Representatives of the mining industry have pointed out that the acceleration of production for war purposes will subject the industry to greatly increased income and excess-profits taxes at the time when it is exhausting reserves that might be produced in later years under lower tax rates. The Treasury is aware that producers of exhaustible mineral resources face a special problem in increasing production by using available reserves, and is studying methods of providing appropriate relief under the excess-profits tax.

This matter was also taken up with the Ways and Means Committee, and while the committee subsequently clearly stated the problem, in its report of July 14 on the current revenue bill, paragraph 10, on page 27, no relief was granted in the bill which the House passed. The report states:

> 10. *Relief for industries with depletable resources.*—War industries with depletable resources, the increase in profits during the war may in part result from stepped-up production which would exhaust the available reserves earlier than under normal conditions. Thus, for the same aggregate output over a period of years, the total amount of profits taxable as excess profits will be greater if the output is concentrated in a few years when if it is spread over a longer period, since the aggregate excess-profits tax credit for the period depends on the number of years. The bunching of income into a shorter period

does not raise the same problem for industries that do not have depletable resources. The increase in their current production need not reduce future production.

With this special situation of mines under the excess-profits tax so clearly recognized, it seems evident that, in fairness to the industry, something should be done about it. The means of effecting the needed relief to the mining industry was indicated in the amendment to the 1941 Revenue Act offered by Senator Johnson of Colorado on September 4, 1941, providing for a "unit of production credit" for excess-profits tax applied to mines. This would allow the normal-profit-per-ton credit, above described, as the fair basis for determining what are to be considered as excess profits in mining. With slight modification in wording to take care of the situation of a taxpayer who did not, during the base period, sell his ore on the open market on a competitive basis and hence did not receive a representative normal market price for his product, the amendment of Senator Johnson would meet this problem of the Lake Superior iron ore industry that we have attempted to present to you.

We trust that our position and request will appeal to your committee as meriting your earnest consideration, and that action will be taken to prevent the application of the excess-profits tax to mines in a manner which is inequitable in comparison with other industries and which severely penalizes mines for their all-out production and exhaustion of their ores in the present war effort.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Harbaugh.

Senator TAFT. Mr. Harbaugh, what does this bonus income provision refer to on page 217 of the bill?

Mr. HARBAUGH. That applies only to the three types of mines producing copper, lead, and zinc.

Senator TAFT. You mean where the Government pays him a bonus because he produces something extra?

Mr. HARBAUGH. That is all it refers to. It is just to bring in some of this marginal production that would not otherwise come in at all.

Senator DANAHER. Does the Johnson amendment contemplate that the normal-profit-per-ton credit shall be based on what would otherwise be described as a representative market price?

Mr. HARBAUGH. That would only be in the special case that I have mentioned here, where certain mines are in the position of being operated by a company for the owner and they turn over their product to the owner at cost.

Senator DANAHER. What do you consider that word "representative" to mean, or what standard do you apply to decide whether it is a representative normal market price?

Mr. HARBAUGH. The price of iron ore is a generally well known figure, a published figure. These operating companies that turn over their ore to the owners, operate at cost; they are not profit companies, you see, and therefore some market price would have to be established to determine what is a fair profit in that case. In other words, there is no profit in the transaction as it is now recorded. It will be up to the Commissioner undoubtedly to determine what was the current, normal price, which could be easily determined from just the general published information about the industry.

Senator DANAHER. Have you prepared some suggested language which would take care of this situation?

Mr. HARBAUGH. Yes; that is the language which was reported by Mr. Fernald in the previous statement.

Senator DANAHER. All right.

The CHAIRMAN. Thank you very much, Mr. Harbaugh.

We will depart from the scheduled list of witnesses for a few moments to see if we cannot maybe shorten some of the testimony.

Mr. Norman.

STATEMENT OF J. V. NORMAN, LOUISVILLE, KY., REPRESENTING CERTAIN COAL PRODUCERS

Mr. NORMAN. If the committee please, my name is J. V. Norman. My home is in Louisville, Ky. I asked for time on behalf of certain coal producers, for whom I am counsel, with reference to the transportation tax on coal.

The CHAIRMAN. Are there other witnesses on that same point, here in the room, Mr. Norman, or do you know?

Mr. NORMAN. Not that I know of. We are satisfied with the provision in the House bill, with the method of assessing the transportation tax on coal.

The CHAIRMAN. Five cents per ton?

Mr. NORMAN. Five cents per ton.

The CHAIRMAN. Rather than the 5 percent general freight tax?

Mr. NORMAN. Yes. It had been our purpose to explain why it was necessary to have a flat tax instead of a percentage tax, but there seems to have been no opposition to the method adopted by the House, and therefore it does not seem necessary to take the time of the committee.

I will say if there has to be a transportation tax, then the method adopted by the House, it seems to us, is the only reasonable one for applying that tax to coal, but if, of course, the tax is to go out on other commodities, the percentage tax, then we would expect it to go out as to coal.

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

Senator DANAHER. Yes, please.

The CHAIRMAN. Senator Danaher.

Senator DANAHER. Judge Fletcher suggested that we strike out the term "long ton" and insert simply "ton." Do you have any comment to make on that point?

Mr. NORMAN. I think the reason for Judge Fletcher's suggestion is that the western roads assess their rates on coal on the short-ton basis, or the 2,000-pound basis. If you made the tax on a long ton there would be considerable difficulty for those railroads to calculate it. I think that is the reason. Of course, that would increase our tax, if you made it on the short ton instead of the long ton. It is not the purpose of those for whom I speak to try to avoid a tax, if there has to be a transportation tax, but I do not think we would quarrel about the short ton, if that would seem to be advisable.

Senator TAFT. There are a number of minor amendments presented by the coal operators. Do you approve of those?

Mr. NORMAN. Yes.

Senator TAFT. Just to prevent duplication.

Mr. NORMAN. Yes. I think, however, that there ought to be another word in there, in that amendment that has been proposed. It should read: "to storage yards" as well as "to washers," because there is a good deal of movement where it just pays a switching charge. Certainly the tax ought not to be assessed until it is a revenue haul, as we call it.

Senator TAFT. I see.

The CHAIRMAN. Mr. Norman, the committee has taken no formal action on the matter, but I have heard no objection to the imposition of the flat 5 cents per ton rather than 5 percent, if this transportation charge remains in with reference to the general class of commodities. I do not undertake to speak for the committee, but I feel that I may be able to say if the 5 percent tax is to remain on other commodities then this committee would not be disposed to upset the House arrangement, so far as coal is concerned, because in reading the testimony before the House committee there did seem to be some satisfactory reason for it, and by a very decisive vote in that committee that provision was inserted.

Mr. NORMAN. Thank you, Mr. Chairman. I would like to say this, though, that should there be opposition to this method of assessing it, we probably would like to be heard.

The CHAIRMAN. Yes, sir. Well, we thank you very much.

There are no other witnesses on that particular point?

Mr. NORMAN. Not that I know of.

The CHAIRMAN. Exclusively on the tax on coal?

Mr. NORMAN. No, sir. There was a general conference yesterday and it was concluded that I would just make the statement that I have made.

The CHAIRMAN. Yes, sir; we thank you very much.

Mr. BERRY.

STATEMENT OF RICHARD F. BERRY, HARTFORD, CONN., REPRESENTING THE MANUFACTURERS ASSOCIATION OF CONNECTICUT

The CHAIRMAN. All right, Mr. Berry. You are appearing on behalf of the Connecticut Manufacturers Association?

Mr. BERRY. Yes, Mr. Chairman.

My name is Richard F. Berry, and I am counsel for the Manufacturers Association of Connecticut. At this time, I would like to introduce Mr. Albert Dixon, Jr., of the accounting firm of Hadfield, Rothwell, Soule & Coates, Hartford, Conn., who is merely acting as advisory counsel to me.

The CHAIRMAN. Yes.

Mr. BERRY. The preliminary statement I would like to make is that the association represents approximately 98 percent of the manufacturers interested in the State of Connecticut; that these companies realize how important it is to raise the greatest amount of revenue by direct taxation in contrast to borrowing. However, the association feels there are certain inequalities which appear in this proposed bill and which I will take up briefly, merely going over the high lights of the points raised in my brief.

On the first matter, in regard to the excess-profits tax, the feeling is that a flat 90-percent rate on excess-profits is entirely too drastic. It feels, in lieu of that, that the excess-profits tax should be based on a

percentage, on a block basis, rather than a dollar basis in respect to the base credit.

As you will see on page 2, there is an example set forth whereby if the net income over the base credit and specific exemption did not make 25 percent of the base credit, the tax should be laid at 50 percent, for example, whereas, if the income over the base credit and specific exemption were in excess of 25 percent of base credit but not in excess of 50 percent the tax should be laid at 75 percent; and in the third bracket, if the income over the base credit and specific exemption is in excess of 50 percent base credit, then the tax should go up to 100 percent.

The effect of this, of course, is that some corporations with less income than double their base credit would probably pay less tax than under the proposed bill, and the corporations whose net income would more than double the base credit would pay more taxes than is proposed under this bill.

In connection with that, I think it advisable to connect this matter up with the suggestion of the association that a post-war credit is to be provided for. If a corporation is to pay 100-percent excess-profits tax we definitely feel at least 20-percent refund should be made after the war. If the corporation paid 90-percent tax, why, the refund of course would be proportionately less, and if they paid 80-percent tax probably no refund should be made at that point.

Another point we wish to bring up, which the association feels is very inequitable, is in regard to the effect of the method of computing excess-profits taxes. As you gentlemen well know, after the excess-profits tax is computed the normal and surtax rates apply to the base credit, which, of course, present an entirely conflicting point of view, because, in the first instance, it is agreed a corporation should be allowed an 8-percent yield on invested capital of less than $4,000,000, and that any amount of income in excess of that yield should be considered excess profits. Now, if you allow a corporation to make an 8-percent yield on an invested capital of $4,000,000 it is not consistent in the next breath to take away that 8 percent by the imposition of a 45-percent normal and surtax rate. The effect of it is that the corporation is really obtaining only a 4.4-percent yield and is losing 3.6 percent. We think that is a definite inequality which should be solved in some manner.

The next point, appearing on page 4, regards the capital-stock tax and declared value excess-profits tax. As has been expressed before in this room this morning, our feeling is definitely that this should be eliminated. There is no rhyme or reason why the Government should force the taxpayer into a gambling game, and, of course, that is all this amounts to. To be sure, the privilege of filing an annual declaration of value is of course better than the former privilege of filing an annual declaration, which, of course, is effective for 3 years, but still we feel that the basic objections remain and that this should be eliminated.

In regard to the excess-profits tax relief provisions, the association feels that these present a very enlightened attitude toward the treatment or corporations which have suffered abnormalities during the base years, and we hope that these provisions will be retained.

In regard to consolidated returns, the association also approves of a plan to allow consolidated returns to be filed not only for normal and

surtax purposes, but also for excess-profits tax purposes, but it does feel that the single $10,000 exemption is unjust, and as a solution, it proposes that for each member of the group for whom the consolidated return is filed, whose net income exceeds its own base credit by $10,000, that $10,000 exception should be granted to that corporation. Of course, against that the loss corporation naturally would not bring in a $10,000 exemption for the benefit of the whole.

I have taken up post-war refunds in connection with the plan suggested for the blocking of excess profits. The association feels that in contrast to the question of reserves for post-war reconversion it favors the principle of post-war refund, because we recognize how difficult it is to agree on what percentage of income should be allowed to be deducted as a reserve, and we feel that the post-war refund is definitely better, and of course, it fits in with the proposition that we are willing to go up to 100-percent excess-profits tax.

The next point, appearing on page 6 of the brief, I will just deal with briefly, and that is deductions for debt payments. I understand that this matter has been presented a number of times before this committee, and that the committee was somewhat favorably disposed toward that. I will merely say we are very much in favor of that provision.

The last point I have to make is in regard to the extension of filing of returns. We feel definitely that an automatic 3 months' extension should be granted to corporations within which to file their returns, provided that a tentative return is filed and payment made before March 15 of the basis of a reasonably estimated tax.

This, of course, will eliminate auditing difficulties and eliminate a great deal of trouble which the public accountant sustains.

The CHAIRMAN. On that point there have been quite a number of messages, letters, and briefs filed with the committee asking for a 3 months' extension in which to file the return. Is not the extension usually granted to the taxpayer now by the Treasury where he has, in a proper case, any just ground on which to base his request?

Mr. BERRY. That is true, Mr. Chairman. Of course, it is up to the discretion of the particular agent in charge.

The CHAIRMAN. Yes; but I mean, has there been any great hardship worked out by that?

Mr. BERRY. I think Mr. Dixon can answer that.

Mr. DIXON. The experience of public accountants in Connecticut with respect to this last year was that the Treasury Department had not released that right to the commissioners until they were right up under the gun of March 15, when it was too late to be of any benefit. We want to avoid any recurrence of that by writing this right into the bill, so the Treasury Department cannot change its mind, or withdraw from the various collectors the right of extension, the way they did last year.

The CHAIRMAN. I thought there must be some reason for it, because of the large number of requests that have been made on that point.

Senator BARKLEY. Do you advocate making it automatic that a 3 months' extension should be granted?

Mr. DIXON. No; but they should have the privilege of exercising it, if they so wish, provided they get their payment in so the Government revenue is not disturbed.

The CHAIRMAN. Provided they pay what is tentatively computed as the tax or as the installment that is due.

Senator BARKLEY. As of what date?

Mr. DIXON. The 15th of March.

The CHAIRMAN. They are suggesting that it be fixed in the law that they should have an extension of 3 months for the final return.

Mr. DIXON. I should like to say this, Senator: I do not think the accounting situation of these corporations and the accounting situation in the public profession has been realized, as to how serious it is. With government reports of all types coming in, it is going to be a tremendous problem on corporate accountants and on the profession as a whole to get these tax returns in proper order and in on March 15, especially with the tremendous volume of transactions that manufacturers are handling today. Any relief you can give us, either in connection with withholding that I think Mr. Berry had some suggestion on, but which he has not touched on, or on the question of the extension of the filing of the return, will assist the Government's own auditors when they come to audit those returns. It will be the difference between having a fussed-up return, that will take weeks to put in order, or one which is made up in good form and in which the administrative expense will be no obstacle.

The CHAIRMAN. We thank you. I was simply curious to know what had developed that led to this plan.

Senator DANAHER. Mr. Chairman.

The CHAIRMAN. Yes.

Senator DANAHER. It is your purpose, Mr. Berry, to offer this brief to be included in full in the record, is it not?

Mr. BERRY. That is correct.

The CHAIRMAN. Yes.

Mr. BERRY. I have one more point, Mr. Chairman.

The CHAIRMAN. Yes; you may proceed.

Mr. BERRY. I believe the last point concerns the question of the withholding tax. I believe that we have received more letters from our members in regard to this point than in regard to any other matter. The companies feel that the clerical and bookkeeping burden which will be imposed is entirely wrong. It furthermore believes that the Government has no right to impose the obligation upon companies to act as a tax collector. However, if it is felt by this committee that this withholding tax must go on, we have an alternative solution to offer, and that is the issuance by the Government of tax anticipation stamps which the employer can give to the employees at the end of each pay period.

This, of course, will eliminate the requirement of furnishing a tax-withholding receipt. These stamps could be given to the employee and pasted in a book, and, of course, represent the amount of money which has been withheld and will act as a credit against the final tax liability.

However, as I say, we strenuously object to that provision, but if it is adopted we do believe this suggestion of a tax-stamp proposition is a much better proposition, from the standpoint of the burden on industry, from the clerical and bookkeeping standpoint.

Thank you very much.

Senator BYRD. Your idea is that the employer purchase the stamps?

Mr. BERRY. Yes.

Senator BYRD. And then resell them to the employee?

Mr. BERRY. Well, the employer would purchase the stamps from the Government, and of course the stamps would be in all kinds of denominations, and if it were determined that an employee was paying a tax of 67 cents that week, why, he would give the employee a stamp in the denomination of 67 cents.

Then, you see, there would be no bookkeeping whatsoever for the employer, and of course the employee would have to be charged with the responsibility of safeguarding these stamps to prevent any dishonest loss claims to be made.

Senator BYRD. That would be deducted from the employee's compensation?

Mr. BERRY. That is correct.

Senator BYRD. At the time it was given?

Mr. BERRY. Yes; these stamps would be placed in official books which would be issued to the employee by the employer through the Government, and then when he would file his return he would merely file the stamp book with it, you see, and the amount of money represented by those stamps in the book would, of course, be credited against his ultimate tax liability.

Senator BYRD. You think that would reduce the bookkeeping considerably?

Mr. BERRY. I think it would reduce it considerably, because under the law now written the employer is required to furnish a tax-withholding receipt at the end of each pay period.

You can readily see, in the case of a corporation, with 30,000 employees, what a tremendous job it would be.

Senator BYRD. That is a very interesting suggestion.

If you haven't covered it in your brief, I think you should prepare a supplemental statement and furnish it to the committee.

Mr. BERRY. I believe it is in here on page 5. I was getting worried about that.

Apparently my page 5 was missing.

Senator TAFT. How many manufacturing companies are there in Connecticut?

Mr. BERRY. I would say there are close to 2,000 what might be called manufacturing companies.

Senator TAFT. And 98 percent of them are members of your association?

Mr. BERRY. That is correct.

The CHAIRMAN. All right. Thank you very much, Mr. Berry.

Mr. BERRY. Thank you, Mr. Chairman.

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

BRIEF IN BEHALF OF THE MANUFACTURERS ASSOCIATION OF CONNECTICUT, INC., SUBMITTED BY RICHARD F. BERRY, HARTFORD, CONN.

It is proposed to take up certain important points regarding the 1942 tax bill as passed by the House of Representatives. Without going too deeply into the policies underlying the observations made herein, the association, which represents 98 percent of the manufacturing companies in the State of Connecticut, feels that the proposed bill contains a number of definite inequalities in respect

to the tax treatment of corporations. Admittedly, the more revenue raised by direct taxation in contrast to revenue raised by borrowing is most desirable. On the other hand, the proposed bill will have the effect, in a great many instances, either because of its provisions or lack of provisions, of threatening the continued existence of a good many Connecticut manufacturing corporations.

These statements are made on the basis of hundreds of letters received from association members, all of which members recognize the fact that a great burden must be imposed on the corporations from the taxation standpoint, but raising the point that the inequalities inherent in the proposed law threaten the continued existence of any of them.

If the proposals submitted herein do have the effect of lessening to some extent the estimated corporate taxation yield, this is a small price to pay to maintain the corporations of this State in a stable financial condition. The estimated yield from this tax bill, as we understand it, is $22,000,000,000. The estimated expenditures for the present fiscal year are $74,000,000,000. Consequently, the Government will be forced to borrow approximately 70 percent of its estimated needs. If, because of the proposal submitted herein, the Government will be forced to borrow 72 or 73 percent of its estimated expenditures, this will not, to any appreciable degree, threaten the economy of this country. Furthermore, any reduction in taxation yield from corporations as a result of our proposals can very well be compensated by decreases in nonessential Government expenditures.

Taking the various points which we wish to discuss in order, they are as follows:

1. *Normal surtax and excess-profits tax.*—These are considered jointly because of the fact that they are so interrelated to each other. First, the association believes that a combined normal and surtax rate of 45 percent, in addition to a flat excess-profits tax rate of 90 percent is confiscatory in nature. It is proposed that the maximum combined normal and surtax rates should be 40 percent. Furthermore, it is deemed undesirable to tax every dollar of income over what is considered as a normal yield on investment or over 95 percent of the average earnings during the base period at 90 percent. There are many cases where corporations on an average-earnings basis would not realize normal earnings during the base period period but for reasons not considered in the proposed excess-profits tax relief provisions. Therefore, a corporation now experiencing what, because of the nature of its business, is considered as normal earnings should not be subjected to a tax of 90 percent on each dollar earned over the earnings during the base period. The same is true in respect to corporations on an invested-capital basis.

It is, therefore, suggested that the excess-profits tax be placed on a sliding scale based on the percentage of income earned in relation to the base credit. Thus, for example:

	Percent
First bracket:	
Income over base credit and specific exemption not to exceed 25 percent of base credit—tax at, say	50
Second bracket:	
Income over base credit and specific exemption in excess of 25 percent of base credit but not in excess of 50 percent of base credit—tax at, say	75
Third bracket:	
Income over base credit and specific exemption in excess of 50 percent of base credit—tax at, say	100

An example computed on the basis of the 1941 act, the proposed 1942 act, and our suggestion would be:

Assume corporation A with 1942 earnings of $1,000,000 and a base credit of $500,000

	1941 act	Proposed 1942	Our suggestion
Normal tax net income (also excess-profits net income)	$1,000,000	$1,000,000	$1,000,000
Excess profits credit and specific exemption	505,000	510,000	510,000
Adjusted excess-profits net income	495,000	490,000	490,000
Excess-profits tax	251,250	441,000	396,250
Normal tax			
Normal tax net income	1,000,000	1,000,000	1,000,000
Excess-profits tax	251,250		
Adjusted excess-profits net income		490,000	490,000
Normal tax base	748,750	510,000	510,000
Normal tax (24 percent)	179,700	122,400	122,400
Surtax			
Surtax base (as normal)	748,750	510,000	510,000
Surtax	52,163	107,100	[1] 81,600
Total excess-profits tax, normal and surtaxes	483,113	670,500	600,250

[1] 16 percent.

Further computations on the basis of our suggestion indicate that corporations earning less than double their base credits would pay less taxes than now proposed, whereas corporations earning more than double their base credits would pay higher taxes than now proposed and rightly so, since such earnings are truly excess profits.

Another proposal strikes at a basic inequality which is deemed to exist under the proposed bill whereby because of the method of computation of the excess-profits tax, the effect is to apply the normal and surtax rates to the excess-profits tax credit. This is unjust because if it is considered that a corporation with a $4,000,000 invested capital should receive an 8 percent yield on such capital, then such 8 percent yield should not be reduced to 4.4 percent by the imposition of the normal and surtax rates of 45 percent, nor, if it is considered that a corporation should be entitled to 95 percent of its average earnings during the base period before any excess income is taxed, should the corporation lose such a benefit by the imposition of the combined normal and surtax rates which of course has the effect of reducing the considered normal and allowable yield to approximately 42 percent. The application of the normal and surtax rates to the excess-profits tax credit therefore conflicts with the theory that a corporation should receive a certain percentage on its invested capital or of its average earnings.

Using the example given above, in respect to a corporation on an invested capital basis, the solution to this problem would be to add 3.6 percent to the allowed 8 percent on invested capital. Therefore, the excess-profits tax credit would be 11.6 percent of its invested capital. The result of this would be that by removing an additional 3.6 percent of the invested capital from the imposition of the 90 percent excess-profits tax would be the same as removing the 3.6 percent from the imposition of the combined normal and surtax rates of 45 percent. Thus using a base credit of 11.6 percent in determining the excess-profits tax credit and then applying the normal and surtax rates of 45 percent to the standard 8 percent credit would put the corporation in a position of not losing the 3.6 percent on its invested capital, which is necessarily lost under the present proposed methods.

If the above suggestions are not adopted, the proposed rates have a very confiscatory effect on the stockholders of this country and the fact should not be ignored that corporations in themselves are nothing but shells and in reality are composed of stockholders. Under the bill as written, with a normal and surtax combined rate of 45 percent, and the minimum normal and surtax on individual incomes being 19 percent, the stockholder is subjected to a minimum tax on his investment of 64 percent. This type of taxation produces a tremendous detriment to the investment market of this country. Under the proposed rates, a corporation would not be able to pay any adequate dividends nor to set up any appreciable reserves for the post-war reconversion period.

2. *Capitol-stock tax and declared value excess-profits tax.*—It is the association's opinion that this tax is not based on any sound proposal of taxation whatsoever. It merely requires the taxpayer to enter into a pure game of chance by himself. The Government should not force a taxpayer to gamble on his earnings. Regardless of the fact that it is proposed to allow an annual declaration of capital-stock valuation, the basic objections to this tax still remain.

This tax is not only unfair to the taxpayer but also can be very unfair to the Government. For instance, a corporation owning real estate for rental purposes could very well determine that its income would exactly equal its overhead and carrying charges and therefore could file a capital-stock tax valuation of $999 with the consequent complete avoidance of any capital-stock tax. Furthermore, with the proposed high rates for normal, surtax, and excess-profits taxes, the capital-stock tax and related declared value excess-profits tax (deductible from income before the application of other taxes) have become meaningless. It is the association's opinion that this tax should be completely eliminated or else put on a sound basis.

3. *Excess-profits tax relief provisions.*—These will be a very enlightened attitude toward the treatment of corporations who have experienced abnormalities during the base years or whose income producing factors are not in the nature of those items which are allowed to be included in determining invested capital. It is urgently recommended that these relief provisions be retained.

4. *Consolidated returns.*—The association approves of the plan to allow consolidated returns being filed not only for normal and surtax but also for excess-profits tax purposes. However, the limitation of only one $10,000 exemption on each return is, in our opinion, too drastic. This should be amended to allow a $10,000 exemption for each member of the group whose unconsolidated net income exceeds its own base credits, plus $10,000. Thus a loss corporation would not receive any exemption, whereas a corporation whose unconsolidated net income exceeds the base credit by $10,000 would receive the exemption.

5. *Fiscal-year taxpayers.*—The association's opinion is that the proposed treatment to be given to such corporations presents the most inequitable feature of this tax bill. The whole theory of American jurisprudence, which allows a person to plan his future policies on existing law, should be equally applied in the field of taxation. If the fiscal year taxpayer is required to pay the increased rates on income earnings since January 1, 1942, Congress has been guilty of lulling such a taxpayer into a false sense of security.

In reality the consequences of this proposal would be very disastrous to all those corporations whose fiscal year has ended and who have made dividend payments, established reserves and commended making capital additions on the basis of the continued application of the 1941 rates. It is a fact within our knowledge that a good many of such corporations, to meet the increased rates on income earned during this year, would not only be required to completely delete such reserves, if any, but also go into debt.

If it is considered imperative that all corporations be treated alike, then the least that should be done is to apply the proposed change to the taxable years beginning 1943.

6. *Withholding tax.*—The association strenuously objects to this proposal. However, it recognizes the necessity of antiinflation measure which this, among other things, presents; it also recognizes the fact that it is most desirable for the Government to receive revenue at current intervals rather than over a year later after income is earned. However, if this tax method is retained, every effort should be made to diminish the burden on industry from a clerical and bookkeeping standpoint.

To provide for this, it is suggested that instead of a corporation furnishing an employee with a tax, withholding receipt at the end of each pay period, the Government issue tax stamps which may be given by the employer to the employee and inserted by the latter in a tax stamp book. When the employee files his return, the book would be filed with it and of course the amount of money represented by the stamps would act as a credit against the final tax liability. Of course this procedure would have to be put on the basis of charging the employee with the sole responsibility of safe-keeping for such a book, as otherwise dishonest loss claims could be made. Whether or not a company would provide for the safe-keeping of these books of course could be left as a matter of agreement between the employer and the employee.

This plan would reduce the amount of bookkeeping and the necessary clerical help to a considerable degree which, especially at this time, should be an objective to be seriously considered.

7. *Post-war refunds—Post-war reserves.*—The association favors the former over the latter, due to the fact that it would be exceptionally difficult to agree on what percentage of tax-free earnings should be deducted for the purposes of establishing reserves. On the other hand, apart from the considerations which underlie the value of such a plan, it would be a simple matter to determine that a certain percentage of the excess-profits tax paid should be refunded in the form of non-interest-bearing bonds at the termination of the emergency period.

With the necessary capital outlays required for war production, and the obligation to continue to pay dividends, it is becoming increasingly difficult for corporations to establish adequate reserves. Furthermore, the English experience has been that taxing income in excess of 80 cents on every dollar earned has seriously impeded the incentive of British industries to produce, even under the dire military circumstances surrounding that country. Accordingly, the English tax system provides that under a 100-percent excess-profits tax a 20-percent refund will be made.

If the suggestions made above under item 1, regarding the blocking of excess-profits rates were adopted, the refund could be made on the basis of beginning at 20 percent where 100 percent excess-profits tax is paid and declining proportionately as the excess-profits tax paid became proportionately lower.

Any post-war refund should be put on the basis of a definite percentage and not left to the authority of any one single person.

8. *Deductions for debt payments.*—The association favors some allowance for the payment of debts which have been either previously incurred, thus inhibiting necessary capital expansion for war purposes, or to be incurred in the future by reason of such necessary capital improvement or because of tax obligations. Many corporations, after the emergency period terminates, will find themselves in the position of having useless inventories, no reserves for reconversion and considerable debt. A post-war refund, in addition to a credit for debt payments, would definitely help to maintain corporations in a healthy financial condition after the emergency period.

9. *Extension of filing of returns.*—We advocate writing into the act specific provision for automatic extensions to corporations of 3 additional months in which to file returns, provided that a tentative return is filed and payment made before March 15 of one quarter of a reasonably estimated tax. This would not affect the collection of revenue but would ease the burden on corporation and public accountants and would result in better returns, more easily audited and with fewer controversies.

Respectfully submitted.

THE MANUFACTURERS ASSOCIATION OF CONNECTICUT, INC.

The CHAIRMAN. Mr. Schieffelin.

STATEMENT OF W. J. SCHIEFFELIN, JR., NEW YORK, N. Y., REPRESENTING THE CHAMBER OF COMMERCE OF THE STATE OF NEW YORK

Mr. SCHIEFFELIN. Mr. Chairman, and gentlemen, my name is W. J. Schieffelin, Jr., 16 Cooper Square, New York City.

I represent the oldest commercial organization in our country, the Chamber of Commerce of the State of New York, with over 1,800 members responsible for directing hundreds of thousands of citizens working in scores of our Nation's leading industries.

Last August 19 you gave me a courteous hearing, and in September Congress approved two of our recommendations, namely, to decrease exemptions on individual incomes and to raise corporation taxes to about 30 percent.

The CHAIRMAN. You had a pretty good average, Mr. Schieffelin.

Mr. SCHIEFFELIN. We also recommended a 50-percent increase in normal tax on individual incomes from 4 to 6 percent. Congress

went beyond this, but turned down our recommendations for either a retail-sales tax or a withholding tax.

Now we are at war. Winning the war is our Nation's major objective. Paying more of the costs currently is essential. Our people, united on the objective, are ready to pay—after every nonessential expense has been eliminated. We appreciate and congratulate Congress on the economies already made along the lines proposed by the Byrd committee and we urge that Congress make even greater economies in military as well as civilian expenditures.

We reaffirm our stand that as much as possible should be raised by taxation to the highest point that will not gravely undermine the national economy; that the balance should be raised by borrowing so far as possible from the current earnings of all the people.

Before presenting the New York Chamber's brief specific tax proposals, our committee on taxation has asked me to make the following statements:

While the good of the country required that heavier taxes should have been in effect months ago, it is the belief of our tax committee that it might now be better to pass a bill smaller than the House bill by reducing proposed normal corporation taxes from 45 to 40 percent, by reducing proposed individual taxes somewhat, and with no increases in present excise taxes, and then immediately after election to raise the required balance by a graduated retail sales tax.

Senator DANAHER. Why do you wait?

Mr. SCHIEFFELIN. May I read you the following paragraph?

Senator DANAHER. Yes.

Mr. SCHIEFFELIN. With reference to such tax, I have the following statement made to me direct on July 14 by one of the leading members of the Ways and Means Committee:

> My belief is that if the Senate writes a sales tax into the 1942 revenue bill, the House will accept it, although you can understand why many Members of the House would prefer not to vote on that issue at this time.

This leads us to the further thought that, late though it is, it may prove to the country's benefit to have no tax bill at all until after election, rather than a bill to go into effect in September or October dominated by election politics.

In brief, we believe a tax bill along the lines recommended below should go into effect as soon as humanly possible; if election politics make such a bill impractical immediately, then a delay of only 1 or 2 months is preferable to a partial disruptive tax law.

We are glad your committee has shown the same courage and good sense as the House in turning down those parts of the Treasury's program which would have no effect on checking inflation and which would be disruptive—namely, mandatory joint returns, tax-exempt State and municipal bonds, and depletion allowance on oil wells and mines.

Senator BARKLEY. You may be a little premature there.

Mr. SCHIEFFELIN. Well, sir, we read in the papers that this committee had tentatively decided to turn these down, Senator.

Senator BARKLEY. I understand. The committee, of course, is still in session and subject to change.

Mr. SCHIEFFELIN. That is true. If those come up for serious consideration again, we should very much like the opportunity of presenting what we believe are compelling reasons against them.

Mr. Morgenthau's anti-inflation aim is sound, but his continued effort to shield the majority of the voters, in whose hands lies most of the increased spending power, from bearing a greater share of the country's burdens, will not work. Either those with more money to spend and others will be taxed more heavily or ultimately inflation will more than wipe out what they think they have gained.

We are completely with Chairman George and Senator Barkley, as he spoke earlier this morning, in their efforts for a drastic tax law that will make another next year unnecessary, so that the millions of good Americans whose time and efforts are now befuddled by tax uncertainties can buckle down 100 percent to winning the war. If election miasma makes such a bill impossible within the next few weeks, please stand up and tell the country so and tell them that in November you will pass the stunning bill demanded by the times to whip the enemy and to keep our money good.

As far back as last February our chamber unanimously approved that $7,000,000,000 of new revenue should be aimed at for the 1943 Budget. Today, with expenditures far greater than those in view 6 months ago, our tax committee approves the proposal of the Treasury that $8,700,000,000 should be raised in addition to the least $18,000,000,000 which the existing tax law is reliably estimated to raise in the current fiscal year. That is, the proposed program actually calls for $27,000,000,000 in Federal taxes alone, in addition to about $10,000,000,000 in State and local taxes, a total tax burden for the Nation of around $37,000,000,000. While our full chamber has not had the opportunity of voting on this, we are satisfied that its long record of advocating sound finance indicates its approval of this position of its tax committee.

The House bill, after some reductions we recommend, leaves some 3½ billions to be raised if this goal is to be attained. In our judgment the only way this additional money can be raised without seriously impeding the war effort is by a Nation-wide graduated general retail sales or consumption tax to be imposed at the point of final sale on all heavy as well as consumer products.

Early this year it was estimated that a flat 5-percent rate would yield close to $4,000,000,000 a year. Today with rationing and so many war products removed from civilian consumption, this figure may well be reduced toward $3,000,000,000.

This amount will be needed, as we believe the Senate will reduce the 45 percent corporation normal tax in the House bill to not more than 40 percent and will substitute a complete retail sales tax for the miscellaneous excise tax increases now in the House bill.

For this war retail sales tax we are strongly in favor of no total exemptions for anything, no matter how necessary. We are inclined to believe that a 2- or 3-percent rate for food and possibly some other low-priced necessities may be advisable if connected with more than the average 5-percent rate on high-priced items and on products containing materials essential for armaments. When we speak of higher-priced merchandise we refer to single consumer items selling for $75 or $100 apiece on which the rates might well be 10 percent or higher.

Such a graduated scale would permit citizens with the lowest incomes to obtain their necessities at the lowest rate and would make those whose incomes have been greatly increased by the war program

pay the highest rates for such luxuries as they desire to purchase, thus tending to have the desired anti-inflationary effect. In operation such a tax at three rates would be scarcely more complicated than a flat rate which, of course, is the simplest. Many stores would only have to collect at one rate.

We believe an equitable war retail sales tax can be worked out on some such basis as this to raise approximately 3½ billions. While this is a larger amount than those familiar with distribution tell us could be raised in normal times without hurting sales and employment, we are sincerely of the belief that as a war tax it will raise the bulk of the required new money with less hardship and dislocation than 10 or 15 or 20 other miscellaneous taxes.

Senator BARKLEY. Why do you recommend a retail sales tax as against a general manufacturers' sales tax?

Mr. SCHIEFFELIN. Senator, may I read the next paragraph which answers that question?

If it does not, I would like to go into it further.

Senator BARKLEY. All right.

Mr. SCHIEFFELIN. *Excise taxes.*—In making this proposal we reaffirm our urgent recommendation that excise taxes be not increased; that the tremendous revenue-producing excise taxes on certain commodities remain as they are, and that the proposed retail sales tax be added to their present retail prices. Some of these products, particularly luxuries and products necessary for armament, should be taxed at more than the average 5 percent. We again urgently call your attention to the fact that this will cause the price increase to the consumer to be exactly the amount of tax actually received by the Government.

Any excise tax or manufacturer's sales tax imposed before the point of final sale pyramids the consumer's cost by a considerably larger amount than the tax received by the Government, due to trade discount schedules which cannot be sufficiently revised without serious damage to distribution.

We submit that this is no time to force the public to pay in increased prices more than the Government actually receives in necessary war taxes. We further submit that a retail sales tax raises no prices; storekeepers continue to ask existing prices and then collect the exact amount of the tax.

Senator BARKLEY. Let me ask you there, how would that work an inconvenience on local merchants who are already collecting a sales tax in the States, and in many cases, in cities?

In New York for instance, you have a city sales tax and a State sales tax.

Mr. SCHIEFFELIN. We have no State sales tax.

Senator BARKLEY. You do have a city sales tax?

Mr. SCHIEFFELIN. That is correct, sir.

Senator BARKLEY. In many States they have a State-wide retail sales tax.

Mr. SCHIEFFELIN. Yes, sir.

Senator BARKLEY. You would add another tax to the retailer. He would have to keep two separate books, to keep the Federal money separate from the State money. To what extent do you think, in your experience and in your position, that would work a hardship on the retailer?

Mr. SCHIEFFELIN. I would think it would work little or no hardship, sir.

I call to your attention that for years in the gasoline stations there have been the Federal and State taxes collected with no apparent trouble at all.

A little example I was about to give here, further answering your question, is this: That last week I went into Wanamaker's and bought a pair of garters. When I gave the clerk a dollar, I pulled a cent from my pocket and said, "Here is a cent for Mr. LaGuardia."

We have gotten used to that. If you give us the sales tax I would say in New York City, "Here is a cent for LaGuardia and a nickel for licking Hitler."

It is really my belief, sir, that the trouble which any new tax is, would be less in the collection and the accounting than these other miscellaneous taxes of which there would have to be a great many to raise the same amount of money.

In other words, in States with sales taxes, or cities with them, the people in business are already used to collecting and accounting for that money.

It is true this would be one more accounting, but we believe the tremendous revenue far outweighs the cost and difficulty of collection.

Senator BARKLEY. Let me ask you this question: The argument has been made against the sales tax, either retail or manufacturers', that people in the lower income brackets eat about as much and wear about as many clothes, for instance, as those in the higher brackets, and that therefore they pay a tax out of proportion to their income.

Mr. SCHIEFFELIN. Yes, sir.

Senator BARKLEY. You have obviously sought to obviate part of that by your graduated tax, putting a lower tax on the lower-priced things and a higher tax on the higher-priced things, but if a flat percentage tax on everything was levied, to what extent do you think that argument applies, that the lower income people would pay practically the same contribution to the war effort as those in the higher brackets?

Mr. SCHIEFFELIN. For food and certain basic articles, you are quite correct, sir; and if there were no graduated tax on the higher brackets, it would certainly not be fair. By present conceptions of fair taxation, it would be out of all proportion, but our answer is that at the moment two-thirds of the consuming public of the country are scarcely touched by income taxes. It would be broadening the base very definitely and our answer to your question is that the steeply graduated income taxes on those in the higher brackets, in our judgment, equalize whatever social injustice there would be if there were no proportionate income taxes on the higher brackets.

Senator BARKLEY. As an anti-inflation method, assuming that taxes are to be levied for some social purposes of that sort, rather than a cold-blooded obtaining of revenue, as an anti-inflation measure, how does a sales tax compare with the lowering of the exemptions among the lower-income group?

Mr. SCHIEFFELIN. I think, Senator, that they are both strongly anti-inflationary. It will make a certain amount of money have to go further in order to get certain commodities of which we all know there is a scarcity, and is going to be worse.

They are both, in our judgment, strongly anti-inflationary measures, and therefore helpful to keeping the dollar up as close to its present purchasing power as possible.

Senator BARKLEY. You advocate also a higher rate of sales tax on articles necessary for the war.

Mr. SCHIEFFELIN. Yes, sir.

Senator BARKLEY. Would not that amount to the Government paying the tax out of one pocket and putting it in another?

If the Government has to pay the increased price on war necessities, would not that be taking it out of one pocket and putting it into another?

Mr. SCHIEFFELIN. When this was discussed in the Ways and Means Committee my understanding was that probably there would be some exemption in the law for purchases made by the Government.

If the Government put a tax on the companies and then had to buy at a higher price, obviously the Government and the Treasury would not be benefited.

The CHAIRMAN. That is in the law.

Mr. SCHIEFFELIN. I understood that it was in the law, sir.

I am talking about purchases to be made by the public.

The CHAIRMAN. All right, you may proceed.

Senator BYRD. May I ask this question? Have you made any estimate of the cost to the average family by your proposed sales tax?

Mr. SCHIEFFELIN. Well, sir, it depends entirely on the family's spendings. If a family spends $1,000 a year in purchases, and, say, the general average is 5 percent, the cost would be $50.

There is a point that the Senator's question brought out, that I would like to bring out here. There has been some discussion by your committee, I understand, of perhaps an excess-profits tax on personal incomes, and we know there are millions that have greatly gone up, particularly in the war industries.

It seemed to us that the handling of that was so very complicated that this high retail sales tax on luxuries, which some of those workers in the war industries can now afford to buy, is, in effect, a graduated excess-profits tax on increased incomes.

People without increased incomes—and there are unfortunately a great many—cannot afford to buy $100 fur coats for their wives. I think there should be a 15- or 20-percent tax on a $100 item, and then the worker who has earned the money and wants to put it into that is paying, in effect, part of his increased earnings to the Government.

Senator BYRD. On the so-called necessities, food, clothing, fuel, and medicine, to what extent would this add to the cost of the average family for those items?

Mr. SCHIEFFELIN. Those items should, in our judgment, be at the lowest rate, either 2 or 3 percent. On the proportion of $1,000 spent, it would be a matter of something under $10, I should say, per family paying those lower rates.

The reason we do not recommend exemptions for those necessities is, as you know, that they are most widely used, and if you exempt anything, and want to raise a specific sum, you have got to raise all the other rates on everything else.

Senator TAFT. Mr. Sheffelin, in Ohio, we do exempt food, and it works very well. Just the one exemption of food, I think, should be

considered, because it would effect a $500 exemption for practically every family.

Mr. SCHIEFFELIN. I think so.

Senator TAFT. It certainly is very much simpler to have one rate. We had food in at first and then we excepted food, that is food sold in stores only, and not in restaurants. My impression is it took about 20 percent off the tax. The estimate made here yesterday was that a 5 percent flat tax would bring in about $2,500,000,000, and by exempting food, it would mean the net tax brought in and would be about $2,000,000,000.

I think your estimate of tax yield is pretty high in your statement. I do not think the sales tax would produce that much.

Mr. SCHIEFFELIN. I am assuming that there are many articles that would be taxed 10 percent. I think if that were done, close to that figure would be raised, based on the estimate.

The CHAIRMAN. You better proceed. The time is getting short.

Mr. SCHIEFFELIN. I do not have very much more.

Capital-stock tax.—In reaffirming our belief that the guesswork capital-stock tax and related declared value excess-profits tax on corporations should be abolished as others have urged today, we realize that revenue needs may make this unwise at present and we heartily endorse the provision permitting annual declaration of value.

Capital gains.—In reaffirming our recommendation that individual capital gains and loss taxes be abolished, we also realize that present needs may make this inadvisable. We urgently recommend, however, that the principle of the Boland bill (H. R. 6358) taxing capital gains at 10 percent be embodied in the present bill. If the revenue-producing arguments for this provision do not satisfy you, then we urge you to leave the capital-gains taxes as they are in the Revenue Act of 1942 at 15 percent. We are satisfied that the proposal urged by the Treasury and embodied in the House bill before you to raise such tax to 25 percent will have such further damming effects on free private transactions that the increased rate will not produce anywhere near the expected revenue, let alone the actual loss from State, and Federal stock-transfer stamps due to fewer transactions.

On April 6, a member of the Ways and Means Committee wrote me as follows:

> Mr. (Elisha M.) Friedman testified at length before our committee and made a favorable impression.
>
> Since only $12,000,000 of revenue is involved, I feel we would be justified in experimenting with the theory of those who claim a lower rate on capital gains would produce more revenue while stimulating the investment of venture capital.

On page 30 of Mr. Doughton's report he stated:

> With a top normal and surtax rate of 88 percent it is not believed that a moderate increase in the capital-gain rate will retard capital transactions.

With that statement we emphatically disagree and we do not consider a 67 percent increase "moderate." I should like, with your permission, to give a pertinent personal example:

Mr. Chairman, in the early 20s my old company, after serious losses, was heavily in debt, with its preferred stock a number of years in arrears in dividends. I was able to purchase a substantial block of its common stock at a very low figure.

In the latter years, my associates and I worked hard. We paid off the debts, and for more than half of that period the common stock has been paying dividends. The time has now come when some of the younger officers and others in the company should have a larger share than they now have in the risks and profits of the business.

There is a capital gain of close to $100,000 involved. I am quite ready to pay $10,000 or possibly $15,000 of my life's savings to the Treasury, but I choose not to pay $25,000.

Now by itself, that little peanut of an example is of small interest to you or the Treasury, but I am informed by my associates that there are literally hundreds of thousands of similar transactions. They do not only involve stock, they involve real estate, and they are being held up because of this, what must be considered a capital levy and we urgently urge you to reconsider this tremendous 67-percent increase proposed by the House in this capital-gains tax.

Please leave it as it is, or look further into that Boland bill whose principles we believe to be very sound, and we predict that the Treasury's revenue will increase with a lower rate, because of the tremendously increased number of transactions that it will bring about.

Withholding tax.—As to a withholding tax, we have advocated such a tax for the past 2 years as an alternative to a retail sales tax. Today we feel that with greatly increased individual rates and a drastic graduated retail sales tax, the imposition of a withholding tax, sound in the principle that it gets revenue into the Treasury immediately and before the taxpayer has had a chance to spend it, should be deferred until our Government imposes an effective price-control law including farm prices and wages, thus insuring that the people's money will continue to buy what they need instead of being chiseled away by creeping inflation.

Senator VANDENBERG. I think that comment is absolutely sound. I think the imposition of a withholding tax would simply result in a general wage increase throughout the country.

Mr. SCHIEFFELIN. Thank you, Senator.

Corporations.—We have stated above our belief that you will reduce the corporation normal tax to not more than 40 percent. We urge you to do this because—

(1) At 40 percent the normal tax plus surtax rates will have been increased from two to three times over the total rates levied on corporation net income of the base period 1936–39.

(2) Many corporations have lower incomes because of the war.

(3) While corporation taxes produce revenue they are not anti-inflationary because they are a primary tax against the more than 10,000,000 security owners who are already highly taxed personally and whose purchasing power has in general decreased, but they do not touch the great mass of industrial workers and farmers who have received an increase of $15,000,000,000 in their income.

(4) Finally, because of wartime uncertainties it is essential that business concerns, particularly small ones, be allowed to build up large reserves to take care of innumerable future contingencies. Such contingencies include the following taken from Dun's Review, July 1942:

1. Accelerated depreciation of facilities as a result of intensive use and of operation by less experienced personnel.

2. Accelerated obsolescence of facilities due to intensive research during the war in an effort to increase productive efficiency.

3. Amortization of the cost of rearrangement and alteration of existing facilities which will probably be rearranged in the post-war period.

4. Amortization of the cost of additional facilities acquired, the usefulness of which is expected to be substantially reduced at the termination of the war.

5. Losses which may be sustained at the end of the war in the disposal of inventories useful only for war purposes, or in the adjustment of purchase commitments, then open, including any amounts which may be paid for the cancelation of such commitments.

6. Losses which may be sustained in the disposal of inventories not necessarily applicable to war production, due to decline in the price level, which, on the basis of past experience, usually follow a pronounced rise in prices.

7. Repairs and maintenance deferred as a result of pressure for war production.

8. Restoration or alteration of facilities to peacetime production at the end of the war, if it is reasonable to assume that such restoration or alteration will be made.

9. Separation allowances which may be paid to employees who were discharged at the termination of the war.

10. Losses from destruction of property as a result of the action of armed forces or from seizure thereof by the enemy.

11. Decline in the useful value of plant and equipment due to excess capacity resulting from war construction.

Because of the need for such reserves, which will be essential for the continued existence of most corporations after the war, particularly small ones, we believe the excess-profits tax should not be in excess of 75 percent, the figure which the Treasury formerly asked and which would require no post-war refunds at a time when such refunds might embarrass the Treasury.

Gentlemen, please ponder on that. This refund you are talking about may come at a time when it would be hard for the Treasury to pay it. If in lieu of this Congress decides on an excess-profits tax at a higher rate than 75 percent, we believe sound policy dictates substantial post-war refunds, which at the last moment the House eliminated contrary to the recommendation of its Ways and Means Committee. In the event of excess-profits tax higher than 75 percent we consider such refunds as an essential backlog for post-war stability.

Our tax committee has asked me to put in one more thing that has been touched on this morning, and that is retroactive taxes on fiscal year corporations. A corporation that has closed its books on the 1st of July this year has been acting under rules in effect, the present law.

If you leave the House provision as it is on that point, it is, in effect, changing the rules of the game after the game is over. I have had many speak to me and say that they paid their dividends based on taxes they believed they were going to pay, and we urge you not to apply this to the fiscal year corporations. When as we hope the time comes to reduce rates, those fiscal-year corporations should continue to pay the higher rate until the end of their fiscal year, and in that way the fairness evens up.

It is considered by business an unfair thing to change the law under which a closed transaction has taken place.

Individuals.—As to individuals, we endorse lower exemptions. As to rates, we believe the House rates should be slightly reduced. If, as we urge, you levy a retail sales tax, all classes of income will pay this new tax.

Gentlemen, I am very nearly through. Mr. Hasler, president of our chamber, who has been president of a Latin American chamber working with the South American countries, has asked me to request you not to terminate the exclusion from gross income, on income earned from sources without the United States. It is hard enough now for American companies to get good people to live abroad, and this has been in effect many years. The present bill proposes to change that, and already some of the men in the foreign field are preparing, Mr. Hasler tells me, to pack up and come home. It would hurt the "good neighbor" policy. This was discussed yesterday afternoon, and we add our plea to those already before you.

Conclusion.—To summarize, our recommendations cut something over a billion from the House bill, leaving the yield from that bill at about 5,000,000,000. We urge you to raise the balance by a graduated retail sales tax of not less than 3½ billion.

Professor Fairchild of Yale said recently:

> There is something absurd in placing our trust in the use of taxation to prevent inflation while at the same time Government continues various of its policies which are definitely and purposely inflationary. The wages and hours policy, certain forms of Government spending, the agricultural policy of parity prices, the silver purchase program and our cheap money, credit and monetary policies, are examples.
>
> No tax structure need be especially devised to combat inflation. The service of taxation in this respect is to check consumer spending. I believe that the best tax system for raising revenue would incidentally be the best one for checking inflation. We need to go after the money where it is. It means sales taxes and withholding taxes.

For 2 years we have urged such taxes. No longer can your upper brackets bear the load. On page 628 of the House testimony on Revenue Revision of 1942 the Treasury itself reports that a 100 percent tax on the income of all individuals over $5,000 would only bring an additional $5,200,000,000. (Such incomes are already paying $3.800,000,000.)

On page 632 of the House testimony Dr. Gustav Stolper punctures the Treasury fallacy that low incomes are appreciably taxed. The incomes of two-thirds of the consumer units of the Nation are in fact substantially untouched, and that is where more than $15,000,000,000 of new spending power is. Tax it, gentlemen, by a sales tax, fairly, rigorously; and the remaining third of our people will pay this new sales tax, too, in addition to the many billions they are already grimly hurling into winning this war.

The CHAIRMAN. Thank you very much.

We do not have time for another witness here, unless some witness desires to make no personal appearance but merely to put his brief in the record. Are there any of the witnesses who are listed who wish to place a brief in the record? We would be very glad to have you do so at this time.

Otherwise, we will recess until 2 o'clock. I might say this: Quite a number of witnesses are here on one or two questions. It would

be very helpful to the committee, gentlemen, if you consolidate your remarks, unless you have wholly different problems that you think ought to be brought to our attention.

(Whereupon, at the hour of 11:55 a. m. the committee recessed until 2 p. m. of the same day.)

AFTERNOON SESSION

(Whereupon, at 2 p. m., the committee met pursuant to recess.)

The CHAIRMAN. The committee will come to order, please.

Senator VANDENBERG. Mr. Chairman, before you call the first witness, I think I had better put in the record a letter to which I referred this morning from Mr. Paul indicating the alternative method by which the Treasury Department proposes to protect renegotiated contracts in the belief that it can be done without amending the law. I ask that the letter go in the record.

The CHAIRMAN. Very well, Senator.

(The letter referred to by Senator Vandenberg is as follows:)

TREASURY DEPARTMENT,
Washington, August 5, 1942.

Hon. ARTHUR H. VANDENBERG,
United States Senate, Washington, D. C.

MY DEAR SENATOR: Reference is made to the enclosed letter received by you from Mr. John Lovett, of the Michigan Manufacturers' Association, Detroit, Mich., dated July 27, 1942.

Mr. Lovett refers to the situation involving renegotiation of Government contracts, and suggests that there should be legislation authorizing the reopening of a taxpayer's Federal income and excess-profits tax return where subsequent to the filing of such return the taxpayer is required to repay a portion of its profits pursuant to a renegotiation.

In such case it is the position of the Bureau of Internal Revenue that under existing law the amount of such taxes may be allowed as a credit or offset against the taxpayer's liability for repayment of excessive profits. The Bureau will advise the War Department, Navy Department, or Maritime Commission, as the case may be, of the amount of such taxes attributable to the amount of any excessive profits to be repaid pursuant to a renegotiation arrangement. Such Departments and Commission plan, so I am informed, to allow such taxes as a credit or offset against the liability for repayment of excessive profits. For example, if the excessive profits amount to $100,000 and the taxpayer has paid a tax thereon of $40,000, the Department conducting the renegotiation will require the contractor to pay into the Treasury only the net amount of $60,000. Under these circumstances the taxpayer will in effect secure the relief which Mr. Lovett has in mind, and it will not be necessary to reopen the tax return. In any case where deemed necessary, a closing agreement under the provisions of section 3760 of the Internal Revenue Code may be entered into for the purpose of definitely fixing the method of treatment for tax purposes. Such agreement will, of course, be binding both upon the taxpayer and the Bureau. Accordingly, it is believed that this procedure will afford the taxpayer adequate relief without legislation. It will provide a more flexible procedure, readily adaptable to variations in specific cases, than would be afforded by rigid statutory rules.

Sincerely yours,

RANDOLPH E. PAUL,
Assistant to the Secretary.

The CHAIRMAN. Mr. Skoner, you are next on the list.

STATEMENT OF LEE J. SKONER, MINNEAPOLIS, MINN., REPRESENTING CONTINENTAL MACHINES, INC., AND OTHERS

Mr. SKONER. Mr. Chairman, Senators, I don't have a formal brief to submit. I have a paper that will take perhaps 5 minutes to review.

The CHAIRMAN. Yes, sir. Are you confining your remarks to the fiscal year?

Mr. SKONER. To the fiscal year and just one point in connection with the fiscal year and the proposed bill as passed by the House.

My name is Lee J. Skoner. I am assistant to the president and financial adviser of Continental Machines, Inc., Minneapolis, Minn.; Savage Tool Co., Savage, Minn.; and Contour Saws, Inc., of Des Plaines, Ill.

My appearance here is in opposition to section 129 of the proposed law which will tax fiscal-year companies at 1942 rates for such portion of their year as falls in 1942, and to present for your consideration a concrete example of the inequity and hardship in this proposal as it affects us and, I am sure, many other corporations.

I am not going into the reasons for the existence of fiscal years. This has been approved for many years; nor will I review the possible tax advantage for fiscal-year companies which, in the long run, may or may not exist. We are chiefly concerned with the retroactive application of this proposal which destroys the efforts of sound business management and nullifies the value of careful advance and future planning.

We are machine-tool manufacturers, a recognized "feast or famine" business. Our fiscal year ends August 31, which was adopted in 1937 without consideration of any possible tax advantage. In 1937 we were a relatively small organization. No one could foresee today's expanded operations or profits. All we were striving for was a sound growth consistent upon our ability to invent, develop, and merchandise a better product.

Today we employ about 1,000 people. The expansion of airplane and other manufacture of war materials has made great demands upon our productive capacity. Machine-tool builders were asked to produce many times the production of preemergency years and their tremendous response is common knowledge today. Like many other of these corporations, we had to enlarge and expand our plant resulting in a dangerously low working capital position. After the close of our fiscal year in August 1941, we carefully planned and budgeted our production and financial program for the next year.

The 1941 Revenue Act was passed in September 1941, and relying on that law as in previous years, we estimated what earnings would be left after taxes at those rates. On the basis of such estimates we built a new plant, increased our inventories which absorbed more than the amount of net profit we could hope to retain. Fortunately, we had only a few stockholders, so we could tell them there would be no dividends. In fact, dividend distribution for the last 5 years has been very meager.

I might add in connection with our expansion, while it may be typical, there is a peculiar situation in our factories. The newspapers have publicized much in connection with the Nazi advances in connection with their tank and airplane activities, particularly, I believe, we have read in connection with Rommel's advance, where he was able to repair his tank and airplanes right on the ground by the use of mobile garage units.

Well, along that line, the United States Army Air Corps and Army, generally, asked us to produce 750 special units to be used in mobile units for our activities, so that we, too, could be in that same position.

In order to provide that additional production, we had to expand. We were also supplying parts and machines for all the airplane manufacturers who too had to be supplied.

So that ours isn't just a normal expansion, but a peculiar situation which demanded we put up a new building and buy new machinery.

The CHAIRMAN. Did you put it up at your own expense?

Mr. SKONER. That was at our own expense, entirely. Thus you can see the profits we have made in the last few years have been entirely tied up in plant, in machinery, inventories, and receivables.

We owe some money to the bank and we will probably have to borrow more to pay our taxes at 1941 rates, but we can work that out in our present planning.

If, however, the present proposal is enacted, all of our previous efforts were for naught, for obviously we could not anticipate or expect that a new tax law would be retroactively applied. A substantial additional tax unforeseen and unprovided for at this time will seriously adversely affect our working capital position.

We are manifestly interested in continuing our efforts in the war-production program and to pay our equitable share of the tax burden. Further, we are likewise interested in the continued and permanent employment of our workmen. We must continue with our efforts to develop and manufacture the best tools and equipment that the human mind can devise to help win this war and to provide for the rehabilitation program to follow. To be able to accomplish this, we must maintain a sound financial policy.

May I emphasize here that every product we produce will contribute to the standard of living after the war. We are not making implements that will be destroyed or consumed. Our machine tools are going into factories which will turn out peacetime goods when the war is over. There will be no conversion necessary so that the machines being sold today will be immediately available for commercial production.

We seriously question the value of our expanded plant in a limited market for our goods. The so-called profits poured into plant expansion probably will never be available to stockholders, but as has happened before to machine-tool builders, will be dissipated in search for new markets. Obviously our survival is critically dependent upon our maintenance of a sound financial position unhampered by unforeseeable hazards and contingencies.

There are admittedly numerous corporations in a position similar to ours. Many will be affected with greater adversity under the present proposal. Dividend policies were formulated based on existing law; financial statements were issued to stockholders, creditors, governmental agencies, and others. Securities were purchased in reliance of those statements.

Certainly, a departure from previous congressional practice in enacting a retroactive revenue act would result in many inequitable hardships which would far outweigh any relatively minor temporary reduction in current revenue.

May we urge, therefore, that in the committee's consideration of the House bill on this proposal, that the retroactive feature be eliminated, that if the method of taxing fiscal years is changed, the application of the 1942 Revenue Act be to fiscal years beginning in the present calendar year.

Senator DANAHER. What is your fiscal year?

Mr. SKONER. August 31. I mentioned it was adopted some 5 years ago, in 1937.

Senator DANAHER. So that if this passed, you would actually be under three different rates in 1 year?

Mr. SKONER. No; just two. The 1941 act and the 1942 act.

Senator DANAHER. Weren't you liable to a tax under 1940—no; you are right. That is correct.

Mr. SKONER. The present and the proposed act.

The CHAIRMAN. Thank you very much.

Mr. Norris.

STATEMENT OF K. T. NORRIS, LOS ANGELES, CALIF., PRESIDENT, NORRIS STAMPING & MANUFACTURING CO.

The CHAIRMAN. All right, Mr. Norris, you are listed here as appearing on the fiscal year, but you are really talking about excess profits.

Mr. NORRIS. That is correct.

Mr. Chairman and gentlemen of the committee, I want to thank you for the privilege of appearing before this committee.

My name is K. T. Norris. I am president of the Norris Stamping & Manufacturing Co., Los Angeles, Calif. My company is engaged in the production of ordnance materials for both the Army and Navy. Ninety-nine percent of our production consists of prime contracts for these services.

At the request of the Army and Navy, we have doubled and redoubled our capacity many times during the past years, and we are now in the process of making another substantial expansion.

We have an excellent production record. We were included among the first 14 companies to receive a Navy E award. Next Monday we will receive one of the first of the new Army-Navy production awards. I mention these awards only to show that we have given our best efforts to this job.

We took our first contracts for ordnance material early in 1938. These involved tremendous financial risks. All of our expansion to date has been made with our own capital. Companies such as ours, by developing the "know how" have made the present production program possible. The knowledge which we have gained through our operations we have freely made available to other contractors.

To pay for plant expansion and make it possible to continue to increase our volume of production, we must have reasonable profits. The only profits we can use are those remaining after the payment of taxes.

A few months ago Congress was struggling with the problem of profit control. There appeared to be two schools of thought: One, that profits should be limited by law; the other, that profits should be recaptured by taxation. To my knowledge, no one proposed that we should have both profit limitation and recapture. Nevertheless, we do have them today.

Government contractors are between the devil and the deep sea. They don't know what ultimate profit they can figure on. It is impossible to make commitments for plant expansion with any degree of certainty that the profits will be available to cover the cost, because there are no specific rules to go by. In fact, such contractors are faced

with the prospect that profits already earned and spent may be demanded by the Government, through renegotiation of contracts already completed. These contractors are faced with the following conflicting and overlapping means of controlling profits:

1. Limitation of profit allowed the contractor at the time the contract is negotiated. This is accomplished by requiring a cost breakdown and then limiting the profit on the original contract price. The effect of taxes is disregarded in that negotiation, only the profit before taxes being given consideration.

2. Renegotiation of the contract price after the cost has been determined.

3. A proposed 90-percent excess-profits tax.

4. The proposed arbitrary and retroactive change in the method of taxing corporations operating on a fiscal-year basis.

The law requiring renegotiation provides for the recovery of any profits determined to be excessive. After the Price Adjustment Board has recovered the so-called excessive profits, the remaining profit is still classified as an excess profit. To a company like ours which has expanded rapidly and has no adequate base-period credit, such remaining profits would be subject to the proposed 90-percent tax.

The reasonableness of the selling price is not taken into consideration. One contractor may sell a product to the Government for $3 and have his profits classified as "excess profits," whereas another contractor may get $4 for the same article and have his profits classified as "normal." The efficient low-costs producer is the one most severely penalized.

The above statements are made for the purpose of providing a background for a recommendation which I am making for adjusting the excess-profits tax credit for those companies which have expanded rapidly. The need for such adjustment has been recognized since the excess-profits tax law became effective in 1940, and some relief provisions have been incorporated in the 1942 law tentatively adopted by the House.

It may be possible that companies such as ours can secure relief under the proposals incorporated in this new bill, although this is doubtful because the wording of the law provides that the changes in the business of the taxpayer occurring since December 31, 1939, shall not be considered.

However, if all companies which have materially increased their volume of business since the base period do come before the proposed board for handling such relief matters, it is probable that this board will be so badly swamped that the prompt granting of relief will be forestalled.

I recommend that a specific relief provision be incorporated in the law to take care of those companies which have expanded rapidly to meet production needs of the Army and Navy. If such a relief provision is incorporated, it will permit immediate relief to these companies and leave the board with only the extraordinary relief cases. We have devised a specific relief provision. This proposal is based on the following assumptions:

1. That normal profits vary in different industries, and that the profits of individual companies in the same industry vary in relation to their efficiency.

Senator BROWN. Mr. Chairman, might I interrupt a moment? Three of us here are on a subcommittee which has a meeting at 2:15, and we will have to be excused for a while.

The CHAIRMAN. All right, Senator.

Mr. NORRIS. 2. That the best measure of what constitutes normal earnings for an individual company is the percentage of profit which that company was able to earn on its sales during a normal period, such as the 1936–39 base period.

3. That as a company increases its volume of sales and consequently increases the amount of services rendered, it is entitled to a reasonable profit on the increased sales without all such additional profit being classified as "excess."

4. That under conditions of war the major portion of earnings must be paid to the Government in the form of taxes, but that some reasonable amount must be retained by the corporation to provide for expansion of plant and facilities, increased inventories and accounts receivable, and to set up a reserve for transition back to peacetime activities.

5. That corporations substantially expanding the volume of sales as a result of the war are not entitled to the same percentage of net profit on sales, after taxes, as was earned during a normal base period.

Our recommendation is as follows:

For each 100-percent increase in the volume of business over the volume done during the base period, the excess-profits tax credit is to be increased 25 percent.

In effect, this proposal means that instead of classifying all of the additional profit resulting from increased sales, as an excess profit, 25 percent of such profit would be classified as normal profit subject to the normal and surtax, and the other 75 percent of such increased profit would be subject to the excess-profits tax.

The above statement presumes that the percentage of profit on sales, before taxes, remains constant. Should the percentage of profit on sales increase, all of such increase would fall into the excess-profits classification and be subject to the proposed 90-perecnt tax.

This proposal and its effect on a representative corporation is set forth in exhibits A, B, and C, attached hereto. In preparing these exhibits, we have used a typical corporation and have assumed its base period sales to have been $5,000,000 and its profits $500,000 or 10 percent. The tax rates used are those adopted by the House, namely, 45 percent combined normal and surtax, and 90-percent excess-profits tax. The effect of this proposal is almost the same for any size corporation except those small companies where the $10,000 specific credit represents a substantial percentage of profits.

Referring to exhibit A, it will be noted that a corporation, which, in the current tax year, had a sales volume of 500 percent of the base-period sales, is entitled under this formula, to an increase of 100 percent in its base-period credit, for the purpose of arriving at its excess-profits tax credit for the current year. Likewise, a corporation which had an increase of 1,000 percent in sales volume would be entitled to an increase of 225 percent in the base period credit.

Exhibit B shows the relative amount of profits to sales which the

taxpayer can retain after taxes, with the proposed adjustment in the base-period credit, and without such adjustment. While the retention has been increased by this adjustment, the percentage of profit is still very low. Without the proposed adjustment all of the additional profits are subject to the 90-percent rate. With the proposed adjustment, these additional profits are taxed at about 79 percent.

At this point I would like to call your attention to exhibit A. By referring to the column for a corporation which has increased its sales 10 times since the base period, you will note that if this corporation earned 10 percent on its sales during the base period it would be permitted to earn 2.389 percent on its sales after taxes if this adjustment which I am recommending is accepted. Without the adjustment it could earn only 1.436 percent on its sales, which amount I consider is entirely inadequate.

Senator DANAHER. When you take your sales figure over the base period, Mr. Norris, are you taking a net figure?

Mr. NORRIS. I am taking a net figure of sales unless the corporation would use the growth formula for determining its credit, then you would have to use the growth formula for arriving at the sales. That would be fair and that would balance out.

Exhibit C has been prepared for the purpose of showing the effect of an increase or a decrease in the percentage of profit to sales as compared with the percentage earned during the base period.

I would like to say that the reason that has been done is that some people have raised the question as to what effect it would have, how much advantage a corporation would get if it had earned 10 percent during the base period, and then it jumped its profit to 20 percent, because conditions were such that they could do so, and you will note here that even though a corporation increases its percentage of profit before taxes from 10 percent—the amount earned during the base period—to 20 percent, very little of this additional profit would be retained by the corporation. Likewise, should that corporation reduce its margin of profit on sales to 6 percent, the net profit retained is not proportionately reduced. In other words, this formula is, to a large extent, self-equalizing.

Now, if you will take a look at exhibit C, and refer to this same tenth column that we were looking at. In exhibit C we find in the bottom group of figures that this corporation which would be permitted 2.389-percent profit on its sales if it continued to earn 10 percent before taxes, would increase this profit to only 3.389 percent if it jumped the profit before taxes to 20 percent. Although the percentage of profit before taxes has been increased 10 points it has increased the retention only 1 point. Likewise, if it should drop this profit before taxes to 6 percent it would retain 1.989 percent after taxes, a drop of only 0.4 of 1 percent.

It is believed that this proposal provides a means of eliminating one of the principal inequities which exists under the present law. We have submitted this proposal to a number of corporations which have grown materially since the base period and without exception the proposal would permit them to retain that small additional percentage of profits which is required to meet the obligations which they have contracted for in connection with expanded facilities. At the same time the necessary incentive is retained to keep costs to a minimum.

I respectfully request your consideration of this proposal and trust that it will be incorporated in the relief provisions of the bill which this committee will report to the Senate.

I would like to ask that these exhibits in this statement be incorporated in the record, and I would also like to make the statement that this proposal was recommended for corporations using the average earnings base, not for those on the invested capital base.

The CHAIRMAN. You ask that the tables be incorporated?

Mr. NORRIS. That is right.

The CHAIRMAN. That will be done, Mr. Norris.

(The tables submitted by Mr. Norris are as follows:)

EXHIBIT A.—*Adjusted excess-profits tax credit—determined by adding a percentage of base-period credit for each 100 percent increase in volume of sales over base-period sales*

Volume of sales to base-period sales	Percentage of base-period credit	Percentage of excess-profits tax credit (adjusted)	Amount of excess-profits tax credit (adjusted)[1]	Volume of sales to base-period sales	Percentage of base-period credit	Percentage of excess-profits tax credit (adjusted)	Amount of excess-profits tax credit (adjusted)[1]
	Percent	*Percent*			*Percent*	*Percent*	
100 percent	100	100	$475,000	700 percent, add...	25	250	$1,187,500
200 percent, add...	25	125	593,750	800 percent, add...	25	275	1,306,250
300 percent, add...	25	150	712,500	900 percent, add...	25	300	1,425,000
400 percent, add...	25	175	831,250	1,000 percent, add..	25	325	1,543,750
500 percent, add...	25	200	950,000	2,000 percent, add..	25	575	2,731,250
600 percent, add...	25	225	1,068,750	4,000 percent, add..	25	1,075	5,106,250

[1] Plus $10,000 specific credit.

NOTE.—Based on corporation with $5,000,000 base-period sales and profit of 10 percent equaling $500,000 base-period credit.

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EXHIBIT B.—*Schedule of comparative percentages using excess-profits tax credit as provided under existing law and adjusted excess-profits tax credit as set forth on exhibit A*

1. Percentage of profits taken in taxes.
2. Percentage of additional profits taken in taxes.
3. Percentage of retained profits (after taxes) to sales.

[Rates: Excess-profits tax, 90 percent; normal and surtax, 45 percent]

	1×	2×	3×	4×	5×	6×	7×	8×	9×	10×	20×	40×
Volume of business (in thousands)	$5,000	$10,000	$15,000	$20,000	$25,000	$30,000	$35,000	$40,000	$45,000	$50,000	$100,000	$200,000
Net profit at 10 percent (in thousands)	500	1,000	1,500	2,000	2,500	3,000	3,500	4,000	4,500	5,000	10,000	20,000
Percent of net profits taken in taxes												
Excess-profits credit:	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
Unadjusted	46.350	68.175	75.450	79.088	81.270	82.725	83.764	84.543	85.150	85.635	87.817	88.908
Adjusted	47.250	68.281	68.625	71.297	72.900	73.999	74.732	75.305	75.750	76.106	77.709	78.511
Percent of additional profits taken in taxes												
Excess-profits credit:												
Unadjusted		90.000	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Adjusted		79.313	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Percent of net profits (after taxes) to sales												
Excess-profits credit:												
Unadjusted	5.365	3.183	2.455	2.091	1.873	1.761	1.624	1.546	1.485	1.436	1.218	1.109
Adjusted	5.275	3.672	3.138	2.870	2.710	2.603	2.527	2.470	2.425	2.389	2.229	2.149

[1] Same percentages apply to all brackets.

NOTE.—Based on corporation with $5,000,000 base-period sales and profit of 10 percent equaling $500,000 base-period credit.

(Above computations based on company making same profit in taxable year as in base period, namely, 10 percent.)

EXHIBIT C.—*Schedule reflecting comparisons*

1. Net profits.
2. Percent of profits taken in taxes.
3. Percent of retained profits (after taxes) to sales.

[Rates: Excess-profits tax, 90 percent; normal and surtax, 45 percent]

	1X	2X	3X	4X	5X	6X	7X	8X	9X	10X	20X	40X
Volume of sales (in thousands)	$5,000	$10,000	$15,000	$20,000	$25,000	$30,000	$35,000	$40,000	$45,000	$50,000	$100,000	$200,000
Net profit before taxes (in thousands):												
At 6 percent	300	600	900	1,200	1,500	1,800	2,100	2,400	2,700	3,000	6,000	12,000
At 10 percent	500	1,000	1,500	2,000	2,500	3,000	3,500	4,000	4,500	5,000	10,000	20,000
At 20 percent	1,000	2,000	3,000	4,000	5,000	6,000	7,000	8,000	9,000	10,000	20,000	40,000
Percentage of net profits taken in taxes:	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
At 6 percent	45.000	45.409	54.375	58.745	61.500	63.261	64.554	65.508	66.280	66.844	69.516	70.852
At 10 percent	47.250	63.281	68.625	71.207	72.900	73.980	74.732	75.306	75.750	76.106	77.709	78.511
At 20 percent	68.625	76.641	79.313	80.648	81.450	81.984	82.366	82.652	82.875	83.053	83.855	84.255
Percentage of retained profits (after taxes) to sales:												
At 6 percent	3.300	3.272	2.738	2.470	2.310	2.203	2.127	2.070	2.025	1.989	1.829	1.749
At 10 percent	5.275	3.672	3.138	2.870	2.710	2.603	2.527	2.470	2.425	2.389	2.229	2.149
At 20 percent	6.275	4.672	4.138	3.870	3.710	3.603	3.527	3.470	3.425	3.389	3.229	3.149

NOTE.—Based on corporation with $5,000,000 base period sales and profit of 10 percent equaling $500,000 base period credit.

The CHAIRMAN. Any questions?
(No response.)
The CHAIRMAN. Thank you very much, Mr. Norris.
Mr. Hayes.

STATEMENT OF T. C. HAYES, TERRE HAUTE, IND., PRESIDENT, LOUDON PACKING CO.

Mr. HAYES. Mr. Chairman.
The CHAIRMAN. Yes, Mr. Hayes. You may be seated if you wish to.
Are you speaking on the fiscal year?
Mr. HAYES. That is right, sir.
The CHAIRMAN. Did you get together over the recess to see if you might consolidate your——
Mr. HAYES. I did not.
The CHAIRMAN. You may proceed.
Mr. HAYES. This will take less than 10 minutes.
My name is T. C. Hayes, and I am president of the Loudon Packing Co.
We are packers of tomato products and V–8 vegetable juices, doing an annual business of approximately $5,700,000, operating plants in Pennsylvania, New York, Ohio, Indiana, and California.
I would like to talk briefly upon section 129 of the House bill which applies the new rates to those months of a fiscal year which fall in 1942.
Our business is conducted on a fiscal-year basis ending June 30. Although a number of industries and individual companies have adopted fiscal year accounting as a matter of convenience or expediency, the fiscal year basis is a practical necessity in the seasonal canning industry. All phases of the year's operation are directly geared to the relatively short manufacturing season. All major costs are established immediately prior thereto and incurred during the season.
Selling prices are likewise generally established before the packing season. Income resulting from the movement of goods following manufacture is, therefore, dependent entirely upon circumstances prevailing at or immediately before the time the pack is made.
Shortly before the next season, inventories of finished goods are at the lowest point. These factors practically require an annual closing immediately prior to the manufacturing season to reflect with greatest accuracy the actual result of the year's operation without the opportunity or necessity for making arbitrary adjustments.
At no other time during the year is it possible to obtain such a picture. Movement of merchandise during the year may ebb and flow, depending upon conditions during any month, and, accordingly, it is possible for the calendar year to produce considerable distortion, particularly in view of the fact that the months of December and January are usually the most irregular periods during the annual cycle.
The Loudon Packing Co. packs only during August, September, and October. Our general practice has been to sell the pack on futures in the preceding spring at fixed prices for delivery sometime after

the beginning of the packing season and throughout the following 12 months.

All of the goods which were packed during 1941 were sold principally in the spring preceding the packing period at prices prevailing at that time. In other words, all of the goods which we sold during the fiscal year ending June 30, 1942, were packed in the calendar year 1941 and the profits were actually earned during a few months of 1941, although realized on later deliveries.

During the 1941 packing season we purchased approximately 45,000 tons of tomatoes and 10,000 tons of other vegetables from approximately 3,000 farmers, and we have made arrangements at the request of the Government to increase this pack approximately 40 percent in 1942.

On June 30, 1942, the books of the company were closed on the basis of the Federal income and excess-profits taxes applicable under the 1941 Revenue Act. Our provision for Federal income and excess-profits taxes for the fiscal year ended June 30, 1942, was 92 cents per share of capital stock issued, based on the 1941 Revenue Act, and net profits after taxes were 57 cents per share.

If section 129 of H. R. 7378, as passed by the House of Representatives, is enacted into law we would be called upon to pay $72,000, or 20 cents per share in additional taxes.

At the request of the Department of Agriculture, we have made contracts with farmers for greatly increased acreage of vegetables at greatly increased prices, to meet the demands for essential foods. We have been instructed by the War Production Board to set aside percentages of our pack ranging up to 38 percent of certain items for direct sale to Government agencies.

To make these increased packs to take care of the requirements of our armed forces and civilian needs, it was necessary to greatly increase our packing facilities, thereby depleting our already limited working capital. We are ready and willing to contribute our best efforts in the production of goods for the war effort and to cooperate with the Department of Agriculture in every possible manner.

To finance the packing of these vegetables we have already incurred obligations to banks and other creditors in maximum amounts based upon our working capital. We have made this arrangement on the basis that our working capital will be increased by our profits for the year ending June 30, 1942, after payment of taxes under the 1941 Revenue Act. We have declared no dividends.

We, as well as the major portion of the canning industry, are notably underfinanced, and operate with very low working capital. Year in and year out the margins of profit in the canning business are very close and the hazards of the business are great.

A detailed survey of the canning industry was made by Dr. Neil Crothers in the years 1930–40 and 1941. In this survey he states:

> The canner who stays in business 10 years without reorganization or composition is not only an able and resourceful businessman but a fortunate businessman as well.

He points out that from 1929 to 1938, 53.6 percent of all canners in business at the beginning of the period were out of business at the end of that period. I would like to submit a copy of that survey for the information of the committee.

Our prices are, of course, subject to the control of the Office of Price Administration. The Price Administrator has been considering the entire problem of the effect of canners' ceilings on distributors and retailers. It is a well-recognized fact that unless price ceilings are adjusted for the distributors, the movement of canned goods during the packing season will be slowed down, thus causing further strain on our limited working capital and warehouse space.

Our company has not paid a dividend to stockholders since 1937 and salaries have been nominal. There is no prospect for payment of dividends in the near future and we have only made small gains in our working capital.

If the 1942 tax rates are made retroactive to include the first 6 months of 1942, it will be difficult, if not impossible, to obtain sufficient credit for us to operate on the volume basis we had planned to meet Government requests.

Due to small profits and this necessity of increasing our packing facilities we have been able to make but a few small additions to our working capital since 1939. To give you a picture of the degree to which our company relies on borrowed credit, our business has grown from $2,500,000 in the year ended June 1940 to a proposed budget of $8,000,000 for the year ending June 1943, without any material increase in working capital, and with only one turn-over a year.

The canning industry operates on a very low invested-capital basis. Tax rates in most cases will have to be computed on invested capital basis because the industry as a whole lost money during the years 1938 and 1939. Therefore, the increased rate imposed by the 1942 tax bill will impose a particularly heavy tax burden on the canning industry as a whole.

The products which we delivered during the second half of our fiscal year from January 1 to June 30, 1942, were in the most part sold to our customers in the spring of 1941 on future contracts at fixed prices, for delivery from the beginning of the packing season in August of 1941 and throughout the following 12 months. This has been the regular sales practice of canners of seasonal commodities. All goods which we sold during our fiscal year were packed in 1941 and the profits were earned during a few months of that year, but realized on deliveries against contracts throughout the year. Therefore, we feel that tax should be applied against profit for that fiscal year at the 1941 rate.

In summation, we request that no retroactive change be made in the tax law as such change would seriously impair the vital effort which canners and farmers are making to obtain maximum packs of essential foods so urgently needed at this time.

Should it be necessary to change the tax year to a calendar basis, this change should become operative at a date following the enactment of the law rather than prior thereto, since plans have been made and contracts entered into before the time that any such tax action was contemplated.

Senator CONNALLY. You mean by that that we ought to put in this bill that the fiscal year would start, we will say, the 1st day of January 1944 and give you a year to adjust that in? Is that what you mean?

Mr. HAYES. No.

The CHAIRMAN. You mean it should not commence to operate except on the years commencing after December 31?

Mr. HAYES. That is right.

Senator CONNALLY. Next year?

Mr. HAYES. After the law becomes effective.

Senator CONNALLY. I am just trying to get at what you mean; 1943 would be a calendar year.

Mr. HAYES. That is right.

The CHAIRMAN. You don't have to go over. You could still go on calculating on the fiscal-year basis, but, of course, there would be trouble.

Mr. HAYES. That is right.

The CHAIRMAN. So you are asking that it not be made effective until 1943, are you?

Mr. HAYES. Pardon?

Senator CONNALLY. Are you asking that it not be made effective until 1943?

Mr. HAYES. I mean it should not be made retroactive until after this past year after we have made our plans.

The CHAIRMAN. 1943 or 1942?

Mr. HAYES. 1942. For the first 6 months of 1942.

Senator BARKLEY. You mean that the calendar-year process ought to begin at the beginning of the next calendar year and not the last?

Mr. HAYES. That is right.

The CHAIRMAN. All right. Thank you very much.

John E. Hughes.

STATEMENT OF JOHN E. HUGHES, CHICAGO, ILL., ON BEHALF OF THE CHICAGO BAR ASSOCIATION AND OTHERS

Mr. HUGHES. Mr. Chairman and Senators: My statement covers three pages.

Last year at the hearings before the committee, reported at page 232 thereof, I testified on behalf of the Chicago Bar Association, which has over 6,000 members in the city of Chicago, on behalf of the needed amendment to section 107 of the Internal Revenue Code concerning the taxation of income earned over a period of years.

In its recommendations to Congress, the Treasury Department has recommended that this amendment be adopted and it is contained in section 128 of the House bill.

The Chicago Bar Association asks this committee to consider it favorably. Most lawyers go along working on a case for 3 or 4 years and at the end of that time receive a fee and, except for this amendment, would have to pay three or four times as much tax on it as if they had received it over the years in which it was earned. As a result of this, under the present very high taxes, they would not have enough money left to pay the bills incurred for their subsistence while they were doing the work on the case. We hope the Senate will agree with the House and with the Treasury Department's recommendation and adopt this amendment.

The next point, Senators, on which I speak is the proposed change in the taxation of fiscal-year companies, and I make this statement on behalf of the National Retail Furniture Association which has over 5,000 members, composed of 80 percent of the retail furniture dealers of the United States, and also on behalf of the United States Mineral Wool Co., a company engaged in manufacturing building insulation.

Now, the furniture dealers business has been harmed by the war, in the first place because one-third of the products which they sell are not being made any more due to priorities and, in the second place, because most of the retail furniture selling is on the installment plan and many men were drafted into the Army and couldn't pay the installments, and most of our members did not repossess the property where there was a wife living in the house. We object to the provision of the House bill which changes the method of taxing fiscal-year companies which has been in existence since 1934.

Starting with the 1934 act, all income-tax laws have provided—see section 1 of the Internal Revenue Code—as follows: "The provisions of this chapter shall apply only to taxable years beginning after December 31," of the year preceding the enactment of the law.

This provision was eminently fair and just because these laws, like the pending bill, were enacted late in the year and hundreds of fiscal-year corporations with fiscal years ending in the early part of the year had already closed their books, filed their returns, and paid their taxes under the rates of existing laws, when the revenue act was passed. It also avoided complex complications in tax computation.

Now, after hundreds of corporations on a fiscal-year basis ending early in 1942 have filed their returns and paid their taxes, issued reports to stockholders in which earnings were computed after deducting taxes at existing rates, borrowed money from banks in reliance on earnings so computed, and in some cases distributed the earnings so computed in dividends or used them to pay old bank loans—which would not have been done had there been warning of this retroactive tax—and also paid incentive compensation to employees based on a percentage of such earnings, it is suddenly and without warning proposed to change the basis of taxing fiscal-year companies, in force for 8 years, and impose a retroactive and unexpected tax upon them and compel the filing of new returns and the recomputation of tax.

Even that great liberal, the late Justice Holmes, condemned the imposition of retroactive liabilities "which, if known, might have induced those concerned to use their money in other ways." The United States Supreme Court, in a unanimous opinion, has said:

> Retroactive laws are, indeed, generally unjust, and, as has been forcibly said, neither in accord with sound legislation nor with the fundamental principles of the social compact.

The only Federal tax laws held unconstitutional during the past 40 years were retroactive laws, of which people had no warning.

If the existing method of taxing fiscal-year corporations is adhered to, it is true the income of months falling in 1942 will not be taxed at the pending increased rates in the pending bill, but this will be compensated for by taxing at the increased rate the months of the fiscal year falling in the first year after the war in which taxes are reduced.

The benefit of the reduction will also be delayed for fiscal-year companies. But they will have warning of this. Hundreds of them are now losing money, although they made money before Pearl Harbor, being unable to operate because of priorities, but will begin selling their product and making money as soon as the war ends.

Also it is generally agreed that the taxes in the pending bill are as great as business can bear and further rate increases are not con-

templated. Hence, as Senator George pointed out at page 338, the benefit, if any, to the Treasury would be nonrecurrent. If the proposed change in the House bill is adopted, it should not be effective until next year, so companies will be warned. Senator Brown pointed out the justice of this at page 351.

In the case of the United States Mineral Wool Co., with a fiscal year ending March 31, there was a loss for that period of the fiscal year which fell in 1942 but a profit for the year taken as a whole. However, this profit was all earned in 1941. Why should a company be forced to file another return and pay taxes at 1942 rates on one-fourth of its income which was earned only in 1941? It has already filed a return, paid its taxes, and used what was left of its earnings in dividends and to pay loans before this change was even proposed. Like many companies, its business has been harmed not benefited by the war.

A number of seasonable businesses where the fiscal year ended in the first part of 1942 have losses in 1942, because of the seasonal character of their business. The salmon business, I am told, is one. They catch all the salmon in August, can it, and sell it, and the Great Lakes shipping business is another. The Lakes are frozen in the winter, and there is no shipping, and there isn't any income but salaries and other overhead go on and many seasonal businesses are in that fix.

The House bill proposes to impose the same portion of the 1942 rates on those fiscal year companies as the number of months falling in 1942 bears to 12 months.

Next I have a statement on behalf of Crane Johnson Co. that section 501 of the House bill shoull be simplified. That point is this: If a corporation was forbidden by State law to declare a dividend because its capital stock was impaired, it could not avoid the undistributed profits tax enacted in 1936 and was caught in a trap. A rich corporation could. It could declare a dividend and avoid it. Surely you would not discriminate against a poor one.

Furthermore, if it had an impairment of capital stock and was organized under the laws of about one-third of the States where corporations in such condition are allowed to declare dividends, a dividend would be a return of capital to the shareholder and no credit for the undistributed profits tax would be given.

There is no reason for granting relief retroactively in the limited cases which may be held to be covered by the vague and ambiguous language of section 501 of the House bill without granting relief in these cases also.

The language of section 501 is vague and ambiguous and ought to be simplified. In 1938 relief was granted as soon as this situation was brought to the attention of Congress, but unfortunately was not made retroactive to 1936. The House bill in section 501 properly makes it retroactive to 1936, but is not phrased in simple enough language.

The next point is that a provision should be put in the Internal Revenue Code that whenever the Supreme Court overrules a tax decision it should not be applied retroactively so as to tax transactions which were tax free when consummated.

All Senators know that in *Eisner* v. *McComber*, 252 U. S. 189, the Supreme Court held a dividend of common stock on identical common

stock was not taxable as income under the Sixteenth amendment to the Constitution.

In *Koshland* v. *Helvering* (298 U. S. 441) it reiterated the rule of the *McComber case*, but said a dividend in stock different in character from that which the stockholder already held was income. Consequently Congress several months later enacted section 115 (f) of the Code which declares a stock dividend is not a dividend so far as it is not income under the Constitution. Congressman Vinson who was in charge of this legislation, expressly stated on the floor of the House that it did not strike at *Eisner* v. *McComber*, but was designed to reach stock dividends taxable under the *Koshland case*. Also, until 1941, Treasury regulations expressly stated a dividend of common stock on common stock was not taxable.

In the *Sprouse case*, to be argued in Supreme Court in November, the Government is asking that *Eisner* v. *McComber* be overruled and all stock dividends held taxable income.

If it is successful in having this case overruled, a retroactive tax will be imposed on all who within the past 4 years acted in reliance on the Treasury regulation and the Supreme Court decision.

Also the Government will lose millions in revenue for it will appear that the flood of stock dividends declared from 1920 to 1930 were income, but the statute of limitations will have run on the right to tax them, and, when sold, their tax-free basis will be their fair market value at the date of their receipt. My suggested amendment will prevent this. It would work both ways—prevent the Government losing revenue and a retroactive tax being imposed.

The next point to which I speak is the proposal to tax 100 percent of all income over $25,000.

Should this or something substantially similar be adopted, most people with fortunes over one million would hasten to spend all over $1,000,000 as quickly as they could, because it would do them no good while living to keep the excess since the Government would take all the income therefrom. Also if kept until death, estate taxes would take the excess. This spending would result in immediate inflation. Also it would be paid to people in lower brackets and the Treasury would lose both estate and income taxes in future years. Then, too, large capital would no longer be available to finance oil prospecting and the development of new industry. Besides, as Senator Vandenberg has pointed out, incomes over $25,000 would only finance the war 4½ days.

The last point is collection of tax at source.

Data from the National Industrial Conference Board shows wage and salary payments constituted 67.5 percent of the national income in 1941. Most of the recent increase in national income goes to families within $2,000 and $3,000 income range. Taxes must come from the increased national income and cannot ignore the place where most of the increase has taken place.

Unless tax is collected at the source, like the social-security tax, many will not have the money to pay when March 15 comes and the expense of collection will be prohibitive.

Thank you, Senators.

The CHAIRMAN. Thank you very much, Mr. Hughes.

Mr. Stokely.

STATEMENT OF WILLIAM B. STOKELY, JR., PRESIDENT, STOKELY BROS. & CO., INDIANAPOLIS, IND.

Mr. STOKELY. Mr. Chairman and gentlemen, my name is William B. Stokely, Jr., and I have a statement here I would like to run over. It won't take me more than 10 minutes, and then I want to file it with the committee.

The CHAIRMAN. You want to run over it and then file it also?

Mr. STOKELY. I am going to run over it a little differently from the way I file it.

The CHAIRMAN. If you run over it fast enough, we will be very glad to have you file it, but if you are going to cover it twice——

Mr. STOKELY. It won't be covered twice.

The CHAIRMAN. Are you on this fiscal year?

Mr. STOKELY. I am on the fiscal year and I want at this point to endorse everything that Mr. Hayes said, but we cover a little different angle, also.

In other words, what he said applies to us, but it doesn't go quite far enough.

The CHAIRMAN. All right. You may proceed.

Mr. STOKELY. I am president of Stokely Bros. & Co., Indianapolis, Ind.

My company manufactures a wide range of canned fruits and vegetables and currently is engaged in a strenuous effort undertaken at the request of the Department of Agriculture and other Government officials to greatly increase the production of most of our items. We are also producing at the present time large quantities of canned rations and other special pack items for the Army, Navy, and Lend-Lease.

I am appearing before you today to attempt to show you the impact of the 1942 tax law as passed by the House of Representatives on our company and the disastrous effect it would have on our part in the war effort.

Along with most of the canning companies we suffered a very severe cyclical depression in our company which covered most of the past period of years which have been selected for excess-profits tax purposes. By reason of these bad years and by reason of large expenditures made to better equip ourselves to take part in the war effort, we have currently outstanding items of fixed term indebtedness with annual maturities amounting to approximately $2,750,000. Of this amount, $711,500 falls due in the current fiscal year which began on June 1, 1942. The most of the balance falls due under a period of the next 4 years with maturities ranging between six and seven hundred thousand dollars per year.

The invested capital of our company at the beginning of our last fiscal year amounted to $6,372,000. It is necessary that we use the invested-capital method in computing our excess-profits credit base as the years in the base period showed very, very little net return. Our excess profits tax credit base on the amount of capital which we have amounts to $496,000. The specific exemptions and net credits for borrowed capital will probably bring our base to around $600,000 which would be set up under the House bill as our normal income and be taxable at the rate of 45 percent. The tax on this $600,000 at the

rate of 45 percent would be $270,000, leaving a net normal earning after taxes which we could apply to debt reduction or other purposes, of $330,000, which, as you will note, is less than one-half of our term maturities coming due in the current fiscal year.

Of course, under the House bill we would be allowed to retain 10 percent of any earnings above the $600,000, which would be considered our normal income, but our earnings would have to be very high, indeed, to enable us to meet these maturing debts. This is because the $330,000 allowed to be retained out of our normal income after taxes if applied against our maturing indebtedness would still leave the sum of $381,500 yet to meet. This would mean that to meet the remainder of debt repayment out of additional earnings would require total earnings of $600,000 plus an additional excess earning of $3,815,000, or a total gross earning before taxes of $4,415,000.

In addition to the term indebtedness we have a preferred dividend obligation to stockholders who have recently agreed to a reorganization reducing the dividend rate on our preferred stock in an effort to help out the company. To earn enough to enable us to pay this dividend which, in good faith, we should do, would mean we would have to earn an additional $2,175,000, or a total of $6,590,000. We do not believe that the Army or Navy, with whom we are contracting, or the O. P. A., who are setting ceiling prices, are going to allow us to make any such earnings.

We have in the past 2 fiscal years invested in excess of $900,000 in additional fixed assets largely for the purpose of increasing our production and adding new products in line with the demands of the war effort. This increased business, together with our decreasing working capital, shows every evidence of bringing us to the point where we are necessarily going to have to reduce our effort and perhaps even liquidate a part of our business in order to meet tax requirements.

Previous witnesses have brought out the effect of the proposal passed by the House to tax fiscal-year companies on a celendar-year basis. In the case of our company this will make a difference in tax for the fiscal year which is closed of approximately $290,000 which would go a long way toward helping us meet our current debt maturities in the present fiscal year.

In addition to the fixed-term debts which I have mentioned, we have to make large seasonal borrowings to carry our peak inventories. We have naturally figured on our income tax for the past fiscal year being on the basis of the year 1941 and the income accrued in this year helping to furnish our working capital for the current year and the base for our credit for the current year. The House bill will undoubtedly make it more difficult for us to finance until some definite disposition of this fiscal-year question is made.

My requests and suggestions are twofold:

1. That no change in provision taxing policy with regard to the time of application of new tax laws on fiscal-year corporations be made.

2. That the 1942 tax law allow deduction of payments made on indebtedness maturing during the taxable year before computing excess-profits taxable income. This to be done only provided debt was contracted prior to January 1, 1942.

This provision not to apply to the final maturity of a term indebtedness such as the full maturity of a bond issue or the like and not to exceed and to be limited to not more than 25 percent of the excess-profits net income. The sums so deducted to be subject to normal income tax and surtax.

Now, in illustration of the impact of this on a small company in the industry, I have reference to this same survey which Mr. Hayes has filed with you, but I will give you one example out of that: An average of a cross section of small companies earn 30 percent on their capital in 1936, 19 percent in 1937, and lose 28 percent in 1938. Now, relating that to a hundred-thousand-dollar company and for the purposes of the illustration, leaving out the specific exemption, assuming this is earned above the specific exemption, that means that over the 3-year period, this company would have netted $21,000. Now, take the case of a more stabilized company in a different base that is not tied so closely in with the farming and crops, and so forth, that earns $6,000 one year, $8,000 the next, and $7,000 the next. That is also $21,000 earnings over the 3-year period, but compare the tax bills of the two companies.

Now, that is the hazard we have in the canning industry, and, frankly, I have made a nuisance of myself coming up with this, but it is very, very serious, and it not only affects our company but every other company in the industry, and I don't see how they will survive under the tax laws as set up.

A third possible alternative would be to allow an alternative excess-profits tax credit basis of 5 percent on the manufacturers' sales price on agricultural products processed by canning or freezing. This would give some recognition to the large increases in production and greater hazards which the industry is being asked to assume today.

The CHAIRMAN. Thank you very much, Mr. Stokely.

Any questions?

Senator CONNALLY. You were here last year, weren't you?

Mr. STOKELY. Yes, sir.

Senator CONNALLY. You got by, though.

Mr. STOKELY. We got by; yes, sir.

Senator CONNALLY. All right.

Mr. STOKELY. The strain is getting tougher this year, though.

The CHAIRMAN. The going is getting harder?

Mr. STOKELY. Yes, sir; it is.

Senator CONNALLY. You expanded, though, a lot, didn't you?

Mr. STOKELY. We did on request and on anticipation.

Senator CONNALLY. You didn't do it just because somebody asked you to do it?

Mr. STOKELY. Well, they are asking us today. The question is, Should we or shouldn't we? From a patriotic standpoint, I think we should. I know we have done a marvelous job in that respect.

The CHAIRMAN. Well, thank you very much.

Mr. Hoyt.

STATEMENT OF FRED HOYT, VICE PRESIDENT AND COMPTROLLER, CARRIER CORPORATION, SYRACUSE, N. Y.

Mr. HOYT. My name is Fred Hoyt. I am vice president and comptroller of Carrier Corporation, of Syracuse, N. Y., and I am appear-

ing here on behalf of that corporation to explain the hardships to our company if the proposed changes in tax rates are made applicable to corporations that operate on a fiscal-year basis.

You all know about Donald Nelson's war production drive. In our attempts to cooperate we put a lot of pep into our suggestion system and not long afterward one of the workmen in the shop walked into the office and said, "Now, gentlemen, if you will get a fixture to go onto this machine that I am working on we will be able to increase our production and cut our costs."

We investigated this idea and we found that by expending a thousand dollars we could save a thousand dollars a year.

Now, with marginal taxes at 90 percent, we would pay $900 of that $1,000 in taxes, and we would have $100 left. In other words, it would take us 10 years to pay for that improvement on that machine.

In normal times we wouldn't consider that good business, but this is war, so we said, "All right. Let's go ahead and order the machines."

Now, with this proposed tax legislation, I don't know how we are going to pay for it.

Of late years we have become accustomed to changes being made in the tax law during the year, and we have learned to defer plans affecting the use of funds, such as for plant expansion, and to defer the publication of reports until the tax rates have been determined finally. However, it has been customary for a number of years past to make such changes effective, for corporations on a fiscal-year basis, to those years beginning after December 31. Undoubtedly many corporations on a fiscal-year basis have made their plans and disbursed funds on the basis of existing tax rates, and published reports that are now incorrect. I am not prepared to talk about these general effects of the proposed retroactive change, but I can talk about our situation wherein it will result in a cash deficit.

Senator CONNALLY. Are you on a fiscal-year basis?

Mr. HOYT. We are.

Senator CONNALLY. When did you change?

Mr. HOYT. We changed on October 31, 1941.

Senator CONNALLY. You just changed last fall?

Mr. HOYT. That is right. I will cover that in a moment.

Senator CONNALLY. Why did you change?

Mr. HOYT. Would you like me to answer that now or——

Senator CONNALLY. No. I will wait. Just so you answer it.

Mr. HOYT. Yes, sir.

Assuming that the bill is passed as proposed, that is exactly what will happen to us. Even though our year ends October 31, the prices and wages to which we are committed cannot be changed and the money already spent or committed for equipment cannot be recovered. The result will be that we will have spent $229,000 which we do not have.

The precedent followed since 1934 in previous tax legislation has led corporate management to rely on there being no material change in the tax law affecting previous years.

Because of this well-known principle, a corporation on a fiscal-year basis has known what its Federal income tax obligations were before it made its plans, and important commitments were made in safety.

We being on a fiscal year basis, had every reason to believe the tax rates were fixed and our tax liability determinable. If we had been on a calendar year basis, we would have known that our tax liability was uncertain and would have conserved all possible funds until we found out what it was. Instead we are now faced with the startling possibility that historical precedent is going to be upset and we are going to be asked to pay out funds which we do not have.

Our company is on the basis of the fiscal year ending October 31. We have known, therefore, for 8 months what our tax obligations were, in accordance with established practice, and we have made commitments accordingly, for capital expenditures, and the investment of cash capital in receivables and inventories necessary to carry on the increase in the volume of business due to our participation in the war effort.

Our completed sales for the 8 months ended June 30, 1942, were $10,768,000, and our net earnings before taxes were $1,284,000. Our bond issue requires that we put into the sinking fund 20 percent of profits before taxes plus $40,000, or $296,000. This left available for taxes and working capital needs $987,200. If this retroactive change is made, and Federal income and excess profits taxes increased by $229,000 to $944,000, we would have left for working capital needs only $43,200.

We have committed ourselves for much more than this amount for new tools and equipment to further our contribution to the war program.

During the 8 months ended June 30, 1942, a statement of the application and provision of funds reveals that our operation, after computing taxes at the known rates, produced funds of $732,000. We used $306,000 to retire debentures, and $174,000 to purchase new tools and equipment necessary to our own war effort, leaving $252,000 to add to working capital. The imposition of an additional tax of $229,000 would reduce this to only $23,000.

Relying on the known tax rates, we assumed that we had this $252,000 available for operations to spend in plant expansion. We have committed ourselves for all of this money. Therefore, if the proposed tax rates are made retroactive, we will have a cash deficit of $229,000.

The question might be asked: "Why cannot this unexpected disbursement be met out of accumulated funds?"

Carrier Corporation is what is known as a growth company.

We are the founders of the air conditioning industry. Its modern history dates from 1930 when the present corporation was formed by consolidating the activities of the following companies: Carrier Engineering Corporation, York Heating & Ventilating Co., and Brunswick-Kroeschell Co.

Since that year, the corporation has expended over three million dollars in the development and refinement of the principles of air conditioning, and their application to many different uses, including various fields of industrial processing, preservation of foods and materials, and for human comfort. All this experimental work adds up to a great contribution to the winning of the war.

Practically the entire output of standard products is going into ships, cantonments, and to the uses of armed forces in the tropics; to

the processing and preservation of foods, to the manufacture of munitions and other war materials where precision work requires the close control of atmospheric conditions; into blacked-out plants. In addition to our regular products, the skill of our engineering staff enables us to contribute as much again to special war work, thereby utilizing our manufacturing space and machinery to the fullest possible extent for the war.

This great contribution to the science of air conditioning, to humanity, this creation of a new and vital industry has prevented the accumulation of a surplus. We couldn't do this job and put fat on our bones. That is what puts us in the position where we cannot stand the shock of such retroactive legislation as this proposed change.

In fact, our corporation is exactly the type that administration economists hold us as a model. If we were the kind of a corporation that has made huge profits and accumulated a large surplus over a period of years, we would have ample funds to meet such emergencies. But we are not. We have made less than nothing since the formation of the present company, and have not accumulated a surplus.

We have paid no dividends; none of the officers or organizers have made personal fortunes out of the enterprise; payments of salaries to officers have always been moderate—the maximum at present is $30,000.

We currently employ about 2,400 people. Our relations with labor have always been good. We have never had a strike, arbitration, or mediation. Our policies are to keep as many employees as we possibly can continuously employed so as to avoid personal hardships in periods of economic stress. We pay wages at least equal to those in the community. We share profits with our employees.

The corporation works continuously to establish lower selling prices, seeking to expand markets thereby increasing employment and service to the community. It is these policies together with the large amount of experimental work which leave the corporation with no cushion of accumulated earnings to absorb the shock of an unexpected drain on its capital, and which make the retroactive fiscal year treatment an impossible burden.

To summarize, Carrier Corporation is a growth company which has expended large sums to further the science of air conditioning, and is thereby making a great contribution to the winning of the war; it follows the pattern of enterprise laid down by the administration economists; because of these things it has accumulated no surplus. It is these factors which make profit margin small and available cash so little that the proposed retroactive fiscal year change would result in a cash deficit. The placing of an additional retroactive tax upon us seriously affects our chance of survival. This standard corporation is in danger of being taxed out of existence.

Legislation that forces small corporations out of existence tends to concentrate the business of the country in the hands of a few large corporations which have accumulated sufficient cash reserves to weather the period of high taxation.

The fact that we are the type of enterprise just described made it necessary for us to borrow money in 1938. We found that those same conditions made the terms of the loan more stringent and we agreed that 20 percent of our earnings before taxes plus a fixed annual sum of $60,000 would be placed in a sinking fund for the

purpose of retiring the loan. We did not agree to this because we like the idea—we had to agree to it to get the loan.

As previously stated, our completed sales for the 8 months ended June 30, 1942, were $10,758,000, and our net earnings before taxes were $1,284,000. From this we have to deduct 20 percent plus $40,000 or $296,800 for the sinking fund, which leaves $987,200. In accordance with the precedent established by legislation continuously since 1934, we knew the tax rate that would be applied against our income and we, therefore, calculated the tax to be $715,000 which left us $272,200.

We are anxious to make certain capital expenditures to round out our facilities for the war effort and for tools and changes necessary to make our facilities useful to the fullest extent. We had the cash available and we spent it for these necessary and proper purposes, and now we find that the precedent that we had properly depended upon is likely to be upset and if so, our taxes will be increased to $944,000. We will have a cash deficit of $229,000, and I do not know where we will get the money to take care of it.

We might be criticized if the $272,200 had been used for dividends or had been paid out in increased salaries, but there were no dividends and the top salary of $30,000 for a company doing $18,000,000 of business annually is not excessive.

Our business is not one of those that have been helped by the war. In fact, we had just begun to reach the point in our business where the years of experimentation were beginning to result in a greatly increased volume when the war changed the normal pattern of our business. Our estimates indicate that our earnings this year before taxes would have been higher without the war than they are now under war conditions. The combined effect of war business and higher taxes is to lower the profit possibilities of the corporation.

Carrier Corporation changed to a fiscal-year basis in October 1941. The management had considered making the change for several years, since the natural business year ends in the fall. When we were on a calendar-year basis, the formulation of new business policies and organization changes were delayed beyond the start of the new selling season, thereby seriously hampering efficient operation. The work of taking inventory, closing the books and preparing annual reports came at the wrong time of year. The rapid growth of our business during 1940 and 1941 made these problems so acute that the management made the change. This change caused us to pay additional taxes of $49,701, no part of which will be offset at a later date. This is due to the seasonal nature of our business, which concentrates most of the earnings in the first 10 months of the calendar year. We could use only ten-twelfths of our excess-profits credit and of the lower bracket provisions of the code.

But in the opinion of our management, the advantages of the change outweighed the tax disadvantage. Of course, the change was approved by the United States Treasury Department.

We urge that the law affecting corporations on a fiscal-year basis remain as it is and that the proposal in the House bill be not enacted. Please do not ask us to attempt to recapture the water that has already gone over the dam.

Now, further on this fiscal year change, Senator, some publicity was given last year to the fiscal-year basis as a device to reduce taxes. We think that is an unsound argument. A temporary tax advantage might be gained in a period of rising taxes, but it is going to be offset in a period of falling taxes.

As I have pointed out, the change actually cost us $49,701 in additional taxes for 1941.

Carrier Engineering Corporation used to be on a fiscal-year basis. In 1930, when the reorganization occurred, a calendar-year basis was adopted. Ever since I became comptroller in 1937, I pressed for a change back to the fiscal-year basis, because it was the normal accounting period. The change was very thoroughly discussed in 1940, and if the change was going to be made because there was a tax advantage, then was the time to make it, but it wasn't made until 1941.

Senator CONNALLY. You guessed wrong.

Mr. HOYT. We didn't guess, Senator.

The CHAIRMAN. Thank you very much.

Senator CONNALLY. Just one question. You have got a very prosperous and growing business, haven't you?

Mr. HOYT. We have a growing business.

Senator CONNALLY. Do you have large outstanding orders? How much outstanding orders do you have?

Mr. HOYT. We have on our books a total of $20,000,000 of orders. That figure contains a good deal of business that we don't know whether we can fill. We have a lot of orders with ratings which are not high enough to bring the material in. Our biggest problem today is the procurement of material.

The CHAIRMAN. Thank you very much.

Mr. Kolb.

STATEMENT OF CLIFTON KOLB, SECRETARY OF THE GLIDDEN CO., CLEVELAND, OHIO

Mr. KOLB. Mr. Chairman, my name is Clifton M. Kolb, and I am secretary of the Glidden Co.

My remarks are in connection with some charts, Mr. Chairman, and if I could use the charts and incorporate them in the record I would like to do it. I have them here and the boys can pull them off rapidly.

The CHAIRMAN. Yes, sir; you may use them if you have some method by which you can—I see you have. You are speaking on this fiscal year change?

Mr. KOLB. Yes, sir; fiscal year change.

The CHAIRMAN. Principally that?

Mr. KOLB. My whole comments are on the fiscal year change. I want to talk first about the Glidden Co., and then I have a few other illustrations I would like to make.

Chart No. 1: The Glidden Co. has been an agricultural and industrial pioneer. It introduced flax growing into California, developed the extraction of protein from soybeans and developed metal powders for use in making bearings. It also supplies cuprous oxide for shipbuilding, and manufactures paint, edible oils, soybean products, chemicals, and pigments. I estimate that $32,530,000, or 43.9 percent, of its 1942 sales, will be paid to farmers this year, and $9,000,000, or 12.2 percent, in wages to its own workers.

Chart No. 2: The Glidden Co. has never made exorbitant profits. Its most profitable year in history was the period ending October 31, 1936. In that year its operating income was only 8.1 percent of its sales, and its net income after taxes was only 7 percent of sales. More recently, its sales have gone up, but both its proft margin and its final net income have gone down. In the fiscal year ending October 31, 1941, its operating margin of profit was only 6.2 percent, and its net income of $3,010,000 was below the $3,085,000 reported in 1936. During the current fiscal year, it is estimated that the profit margin will drop further to 6.1 percent.

Senator CONNALLY. Is that on your capital stock or your sales?

Mr. KOLB. On our sales.

Senator CONNALLY. Which is the biggest, your capital stock or your sales?

Mr. KOLB. Our sales. Net income based on existing tax laws will fall to $2,550,000. This is a profit of only 3.4 cents on each dollar of sales.

Senator CONNALLY. Why don't you say how much you are making on your capital stock?

Mr. KOLB. Last year we earned 9.7 percent on our total capital and surplus. We made $1.40 on our common after taking care of our preferred.

Senator GUFFEY. How much preferred did you have and how much common?

Mr. KOLB. We have $8,000,000 preferred and our common is no-par with a surplus. Our preferred is $9,997,000. Our common at a declared value of $5 a share is $4,000,000, which makes $14,000,000. Our capital surplus is $8,000,000, our earned surplus is $8,942,000, and we have some stock in the treasury which comes out, making our total capital value $31,396,000, on which we earned 9.7 percent, or $3,010,389.92.

Senator CONNALLY. On a capital stock of $5 you made $1.40?

Mr. KOLB. According to our president's letter last year—let's see what he says—$1.55. I was wrong about the $1.40. It was $1.55.

Senator CONNALLY. The common stock made that after you paid all the——

Mr. KOLB. Here is the statement, Senator.

The annual report of your company for the year ended October 31, 1941, is submitted herewith. The net profit for the year, after taxes and all charges, was $3,010,389.92, equal to $3.08 per share on the outstanding common stock. This compares with a net profit for 1940 of $1,727,828.99, equal to $1.55 per share.

So we earned $3.08.

Senator CONNALLY. On the $5——

Mr. KOLB. That is the declared value in Ohio.

Senator CONNALLY. That is the way you figure it, isn't it? That is pretty good. That is 60 percent.

Mr. KOLB. No, Senator, we did not earn 60 percent on our common stock. The stock has no par value, but in Ohio you state any amount you wish as the "stated value" and add the rest of the capital contributions to capital surplus. Our common stock was sold at different prices, the highest being $50 per share, on which $5 went into capital and $45 into capital surplus. An earning of $3.08 for those who contributed $50 to our company is 6 percent.

Senator CONNALLY. It ought to be worth a whole lot more than $5.

Mr. KOLB. The capital surplus on our books is $8,000,000, and the declared value was $4,000,000, which makes the common $12,000,000. And there are 835,000 shares outstanding.

Senator CONNALLY. All right.

Mr. KOLB. The Glidden Co. has used a fiscal year ending on October 31, since the year 1922. This closing date was adopted because it represented the low point in both operations and inventory in the paint business. Inventory could be taken on that date with the least disruption in manufacturing schedules, and the accounting department had less normal work to interfere with the arduous task of closing the books for the year.

Since 1922 the company has greatly expanded its business in other fields through its food division, pigment division, metals refining division, and soya products division. Because of this change in the character of its business, it has frequently considered the advisability of changing to some other fiscal period. However, after detailed studies of this situation, it was always decided that October 31 continued to represent the most satisfactory closing date.

Chart No. 3: Out of the $2,550,000 which the company estimated it would earn under the present tax law, it has spent, or obligated itself to spend, $1,500,000 for necessary plant expansion. Out of the remaining $1,050,000 it has paid a total of $998,674 in dividends, leaving a balance of $51,326.

However, if we are required to pay an additional $550,000 in taxes, we will be short $498,674. In other words, the company will be placed in the position of having paid out to its stockholders dividends substantially in excess of its earnings available for this purpose.

Senator TAFT. How long have you paid dividends on about that basis?

Mr. KOLB. What was that, Senator?

Senator TAFT. How long have you paid dividends on about that basis?

Mr. KOLB. We have been paying on a similar basis for about 8 years, 1936 being out best year. Prior to that it was considerably less. In 1933 we had a low dividend and in 1934 not very much.

Chart No. 4: In making plans for the 1942 fiscal year, the company relied, as in every year since 1934, on the provision in the 1941 Revenue Act which made its rates applicable to all fiscal years beginning after January 1, 1941. On this basis, it entered into negotiation for bank loans to provide sufficient working capital to handle its anticipated sales volume.

Those bank loans, now amounting to $3,000,000, were obtained on the basis that they would be, at least in part, of a seasonal nature, and that some reduction would be effected before the close of the current fiscal year. These bank loans are in addition to $7,000,000 of funded debt which the company is obligated to pay off at the rate of $1,000,000 a year on each July 1 of the years 1943 through 1946, and $3,000,000 on July 1, 1947. This total debt of $10,000,000 represents an increase of $2,000,000 as compared with October 31, 1941.

At the present time the company's cash balance is only $2,000,000, which represents the minimum amount needed to carry on the present volume of business.

Due to the seasonal element in the business, it is expected the inventories and receivables will be reduced sufficiently to bring this balance up to $2,500,000 by October 31, which would permit paying off in cash $500,000 of the company's obligations to the banks.

However, the proposed change in the tax law, which would require the company to compute ten-twelfths of its taxes at the 1942 rates, would make it obligated to pay about $550,000 in additional taxes. Payment of this additional amount in taxes would make it impossible for the company to carry out its commitment to reduce its bank loans, and still carry on its business in a normal way.

As already stated, the company has suffered a decline both in its profit margin and its net profit, and it can in no way be regarded as benefiting from the war. The company has been steadily replacing its peacetime business with war contracts and subcontracts, but the latter have been obtained on a competitive bid basis, resulting in lower prices than those obtained on the displaced civilian business.

In bidding these low prices, the company has relied upon the assurance given by the 1941 Revenue Act, that the small operating profits resulting therefrom would be taxed at the 1941 rates.

Much of the strain being placed on the company's financial condition by the necessity for expending $1,500,000 for capital expenditures can be attributed directly to the war. In addition to normal capital expenditures amounting to $405,000, it has been urged by the Department of Agriculture to build a $500,000 addition to its soybean protein plant to produce protein which can be substituted for casein. Another $400,000 has been rendered necessary for two hydrogenation plants because hydrogen is no longer available.

Other items which bring the total to $1,095,000 are: $85,000 to convert power plants from oil to coal because it is hard to get oil; $50,000 to acquire a new supply of Ilmenite, which was formerly obtained from India, we no longer have boats; $40,000 for a warehouse to store flaxseed, you can't get bags any more; and $20,000 to build storage tanks, thereby releasing oil tank cars for other needed purposes.

To summarize, the company is contributing greatly to, but not benefiting by the war effort. In fact, it is being harmed by the war, which has reduced profits, and necessitated substantial additional capital expenditures. The company's shortage of working capital has necessitated heavy bank borrowings, which have been obtained on the basis of earnings estimated under the 1941 act, which indicated the company's ability to reduce them during the current fiscal year. However, if the proposed retroactive change in the tax laws is made, the company will not be able to fulfill its commitments to the banks, and it will be placed in the position of having distributed to stockholders dividends substantially in exces of earnings available for this purpose.

Chart No. 5 shows how this affects the Andrew Jergens Co. Their experience is similar to ours, although their difficulty results from a different cause. They spent their money over a period of a couple of years to build additions to their plant, and they arranged for the payment of them by bank loans. If they are taxed under the 1942 rates, they will not be able to pay back to the banks on their their loan the amounts committed.

Back in 1938, when 10,000,000 people were unemployed and every agency was urging business to help solve the problem, this company decided to expand its business and build a new plant. The blueprints were drawn in 1938, the land purchased April 5, 1939, the plant occupied January 2, 1941, and fully completed July 1, 1941. For this purpose, the company borrowed $1,175,000, the last portion of the loan being made in December 1941. It expenses, including tax payments, were carefully budgeted and included making a repayment of $500,000 on the loan in 1942.

Chart No. 6: This company (the Andrew Jergens Co.) is and has been on a fiscal-year basis for some years. Its fiscal year ending November 30.

The proposed change in tax base will make them $400,000 short of estimated repayments.

Continued renewals of the bank loan will be uncertain. The bank may force repayment out of working capital. This company, therefore, would be forced to curtail its business and meet a rising tide of cost with a small volume.

Its immediate difficulties are all due to the fact that in December 1941, when it made the bank loans and arranged the repayment basis, it was justified in believing that its fiscal year basis would not be changed retroactively.

Chart No. 7: Since 1934, the Treasury Department has eliminated confusion by advocating that the revenue act of any year be applied only to a fiscal year beginning in the year of the act. Will we now return to the former confusion?

Chart No. 8: Why do companies use the fiscal year?

It has been hinted that it is done for the purpose of saving taxes. The fact is, that every company of which I have knowledge, which uses the fiscal year, started doing so long before there could have been any possible favorable tax effect.

The reason for the Andrew Jergens Co. choosing November 30 is that it sells to the retail trade who are too busy in December to see the company's salesmen or to send in orders. Their cycle of buying raw materials, manufacturing, and selling ends in November.

Chart No. 9: The Spencer Kellogg Co.'s report, in part 5 of the hearings of this committee, is an excellent example, as shown in the following chart.

You will see on this chart that their fiscal year ends the last week in August and at that time they have a large cash balance and no inventory. Now, if they close their year in January or at the end of December, you can see on the chart that they would have an enormous inventory and they wouldn't know the value of it and they wouldn't be able to determine their profits. A financial statement at that time would be meaningless. That illustrates that point.

The company begins its fiscal year during the last week of August with practically no inventory but with cash on hand for the purchase of inventory.

From August until December it uses about $38,000,000 buying crops from American farmers, with the result that in December the cash is low and the inventory high. Inventory purchases cease then and manufacturing and selling begin, with the result that at the end of July cash is again high and inventory low.

Suppose that the company used the calendar year? On December 31 it would have from thirty million to fifty million dollars of inventory, and it could not possibly determine its profits. A financial statement made at that time would be utterly valueless.

Farmers, as you know, are all engaged in a seasonal business, with the result that most firms dealing with agriculture need a fiscal-year basis. Practically all in the beet-sugar industry are on this basis.

The Niagara Sprayer & Chemical Co. sells spraying machines and insecticides to farmers. They are on the fiscal year ending November 30, because they cannot collect from their farming customers until fall. They begin manufacturing their products on December 1 and complete shipments by August 15. Then they begin collecting and complete this on November 30.

It would be very difficult for any firm dealing with agriculture to operate on the calendar-year basis.

Chart No. 10: Spencer Kellogg's testimony shows that applying the calendar year to a company whose business cycle ends at another period makes an annual statement worse than "counting your chickens before they hatch." It is pure crystal gazing.

Chart No. 11: On March 19, 1940, Mr. William N. Werntz, chief accountant of the Securities and Exchange Commission, recommended the fiscal years, stating:

> * * * the advantages to be obtained from the adoption of a fiscal-year-end date which coincides with the lowest point in the annual cycle of operations are clear, and to my mind have never been shown to be outweighed by related disadvantages.

Mr. Werntz continues listing the advantages which I shall not take time to read.

Chart No. 12: Having recommended in 1940 that corporations use the fiscal year basis, the S. E. C. again reaffirmed this stand 3 months ago.

Mr. Werntz stated:

> * * * the advantages are obvious * * * I have discussed with the Commission the possibility of rules requiring a changeover to the natural business year.

With the S. E. C. making such recommendations to business, anyone who takes the position that corporations should not change to the fiscal year basis, which serves their business best, is pretending to know more about the subject than the S. E. C.

Chart No. 13: I am recommending a change in the House bill, not because it injures our company alone, but because hundreds of companies in various industries—some of them vital to the war—will suffer in many ways, for example:

Chart No. 14: The next chart illustrates a hypothetical case, similar to the one previously mentioned in this committee by Senator Taft, on page 79 of the hearings. I have been told, however, that there are actual cases which fit this situation.

This company's fiscal year ends in May. Its capital is $1,000,000 and surplus $5,000. In May 1942, after the payment of all taxes under the law then in existence, it had $80,000 left over, and as it could show no serious need for accumulating this income, it was required, under section 102, to pay it out in dividends.

If the fiscal year change is included in your bill, and the tax law is passed in September 1942, it will then be forced to pay $15,000 in additional taxes, of which $5,000 will come from surplus and $10,000 will come out of capital.

The New York State law, like the laws of many other States, says: "No corporation shall pay any dividend which shall impair its capital." This company will be in the position of having violated that law due entirely to the retroactive action of your committee.

Chart No. 15: The next chart illustrates how another company will be kept from meeting commitments made in good faith.

On November 24, 1941, the corporation borrowed $2,500,000 with promises to pay back $420,000 a year. The money was borrowed for increased working capital purposes, caused largely by having to pay higher prices to farmers for raw material and higher wages.

Prior to August 1942, the company paid out approximately $900,000 in essential capital expenditures and $900,000 in dividends.

If the tax law is changed during August 1942, regarding fiscal years, it will cost this company $600,000.

The company will have great difficulty in paying both $420,000 to the bank and the $600,000 unexpected retroactive tax.

Chart No. 16: The administration says that the only way we can avoid future depressions is to maintain full employment.

Various administration leaders also claim that to maintain full employment, we must do two things, namely:

1. Maintain high wages, thereby putting more purchasing power into the hands of the masses, who will buy more products, causing more production, and, in turn, causing more employment.

2. We must maintain low prices so that more people can buy the products, with the result that more products will be produced and more people employed.

If the above is correct, we must accept the fact that companies which follow this administration pattern will have smaller profits. Part of the plan is to provide smaller profits to wealthy corporations and their wealthy owners who do not use large profits to buy more hats, shirts, or radios. Instead of going to the wealthy, they want these profits to go to the masses, who will buy more of such materials.

But small profits and reduced surpluses make it impossible for such corporations to meet unexpected demands, such as this change in the fiscal-year tax provisions.

Chart No. 17: What would be the effect of a fiscal-year change on an actual company that fits the administration's pattern?

Chart No. 18: On the right-hand side of these charts (your left) we show what happens to an actual company that has for years had high wages, low prices, and low profits. This company has never paid out $1 in dividends. It fits the pattern of the administration's formula for a model company.

During 1941, it earned before taxes $1,746,000.

From this, it first deducted taxes of $899,000; then its sinking fund requirement of $349,200; next, essential capital expenditures of $355,000. This left $142,800 of surplus available for other corporate purposes.

On the other side of this chart, we show what would happen to the same company under the fiscal-year change. From the earnings of

$1,746,000, it must first deduct taxes of $1,175,000; then the sinking fund requirements of $349,200; also, essential capital expenditures of $355,000, which it has already made. This leaves a deficit of $133,200.

Chart No. 19: This company, like all other companies with low prices, high wages, and low earnings, will have great difficulty in meeting this deficit. Can it be paid with a bank loan? Such companies must sail close to the wind and cannot get additional loans from the bank. A loan from the Government? What good would it do Uncle Sam to loan $133,200 with one hand and take it back with another?

Chart No. 20: Here is another actual case. Company C will have paid out $610,000 too much in dividends under the proposed law. Its earnings are $4,000,000. It has already made unusual capital expenditures of $900,000. It has already paid in dividends $967,504.70. It could afford both of these items because the estimated taxes under the 1941 law are $2,150,000.

But if the law is changed the tax will be $2,760,000, creating a deficit of $610,000.

Chart No. 21: If this change is made in the law some companies will be sunk without warning.

Chart No. 22: The next five charts will illustrate five different kinds of confusion that will be caused by the proposed change in the law.

1. Accounting.
2. Making required official reports.
3. Treatment of capital gains.
4. Treatment of gains in one calendar year and losses in another.
5. Interpreting the bill.

Chart No. 23: The first confusion is permanent accounting difficulties.

1. The United States Government allows 2½ months from close of fiscal year to file tax return (June 1).
2. The New York Stock Exchange allows 3 months from close of fiscal year to make report (June 15).
3. The S. E. C. allows 4 months (July 15).
4. The tax bill will probably be passed 6 months after close of fiscal year.

Now, if you have a fiscal year closing in February you would have your reports all filed with all these people, and you would have to go back and change them all because you would have to pay more taxes because of this change in the tax bill.

Chart No. 24: The second confusion will be in connection with making the required official reports. Various agencies, such as S. E. C., New York Stock Exchange, stockholders, banks, Dun & Bradstreet, Statistical Manuals, and so forth, all must be informed of the changes in the reports made to them.

Chart No. 25: The third confusion is in the treatment of capital gains. I understand, as far as the Glidden Co. is concerned, being on a fiscal-year basis, that if we have capital gains, we have to pay 31 percent normal-income tax on those gains for November and December, and we have to pay 45 percent on our capital gains from January to the end of October, due to the fact that the present law has a rather confused provision in it that calendar-year companies don't get the benefit of this 25 percent on capital gains until the beginning of the

next fiscal year, which would be up November 1 as far as the Glidden Co. is concerned.

That is something that I have an explanation of here by the lawyers, and I will be glad to leave it here with the committee.

This chart illustrates that. That is the way it will affect the Glidden Co. if we have capital gains.

Suppose that the long-term capital gains realized during 1942 amount to blank dollars.

The maximum tax of a calendar-year corporation is, as stated in the bill you are now considering under section 136, 25 percent. But the same bill would require this fiscal-year corporation to pay tax in excess of 43 percent. I hardly believe that such was the intention of the members of the Ways and Means Committee or that it is your intention.

Chart No. 26: The fourth confusion—seasonal earnings.

As a matter of fact, in many cases the proposed retroactive tax will penalize fiscal-year corporations because of their seasonal business. In the illustration at the top of the chart, we have a calendar-year company whose seasonal earnings are all made during the last two quarters—$100,000 during the third quarter and $200,000 during the fourth quarter. All of the 1941 earnings were, therefore, taxed at 1941 rates.

If the same company follows the advice of the S. E. C. and changes to a fiscal-year basis, as most seasonal companies should, we find in the lower illustration that the company earns $300,000 during the last half of 1941 and nothing during the first half of 1942. Your proposed law would tax one-half of the 1941 earnings at 1942 rates and would penalize the company for following the recommendations of the S. E. C.

Chart No. 27: The fifth confusion is in interpreting the bill itself. We believe that there is an indication in the testimony given by Mr. O'Brien to your committee that it will be practically impossible to draft this section of the bill on a basis that will be fair, complete, and understandable.

In 1934 Mr. Beeman and other expert draftsmen evidently decided that the present system was the clearest and simplest plan. The report of your committee to the Senate, dated March 28, 1934, stated:

> This complicated rule has been eliminated in the present bill for the purpose of simplicity and ease of administration.

The House is trying to get you to eliminate what you called "simplicity and ease of administration" and replace it with what you called "this complicated rule."

I have had great difficulty in understanding this section of the bill.

Most taxpayers will have the same difficulty.

Chart No. 28: Even your own advisers disagree as to what this bill says. The quotation on this chart was obtained from page 81 of your unrevised hearings.

> YOUR ADVISER No. 1. We have provided in this amendment that those corporations who are required to pay any additional tax due to the 1942 rates can file a supplemental return on March 15 of next year and pay that tax. In other words, they won't have to file the return before that time.

* * * * * * *

ADVISER No. 2. There is no such thing in the bill on that point.
ADVISER No. 1. We talked about it.
ADVISER No. 2. Something needs to be done about it. I want to say that the bill does not provide for any such thing.

Chart No. 29: The illustration on the next chart is not original with me. I believe that it originated from someone in the Treasury, probably someone in Mr. Ray Blough's department.

The fiscal year change will produce very little, if any, net revenue.

As rates go up year after year, fiscal year companies pay less than those on a calendar year. Then when rates go down, they pay more.

Surely the final result is not worth all the grief it causes.

Chart No. 30: Is a fiscal year change required to prevent corporations from using this procedure to save taxes?

If so, this can be prevented without penalizing the proper and necessary use.

How?

Corporations cannot change to a fiscal year without securing the consent of the Commissioner. Aren't you willing to assume that the Commissioner will not give this consent if the change is to be made merely for the purpose of paying lower taxes? I believe that you would be safe in doing so.

If new companies are also required to secure the Commissioner's consent, then no corporation could select this basis without approval of the Treasury.

Chart No. 31: There are two ways to prevent misuse of the fiscal-year provision. These two ways apply to misuse of anything in life. They are:

First. The hard way—that is, to seek out the guilty ones and punish them only.

Second. The easy way—make no effort to find the guilty ones but punish all who use the fiscal year—good and bad alike.

In the Bible stores the sheep were always separated from the goats and the wheat was saved while the tares were burned up.

Chart No. 32: The following story has been told regarding the Czechoslovakian village of Lidice. I do not know whether or not it was true. The story goes that when someone in Lidice killed a member of the Gestapo, an agent of the Gestapo reported to the commander that it would be difficult to find the guilty party. He nonchalantly replied, "Ach, just kill them all." They took the easy way and shot every man in the village.

We believe that this committee can find a way to prevent the improper use of the fiscal-year basis without punishing the innocent along with the guilty. In doing so, I respectfully submit that you cannot accept the present proposal of the House.

Thank you, gentlemen.

The CHAIRMAN. Thank you, sir.

(The charts submitted by Mr. Kolb are as follows:)

CHART NO. 1

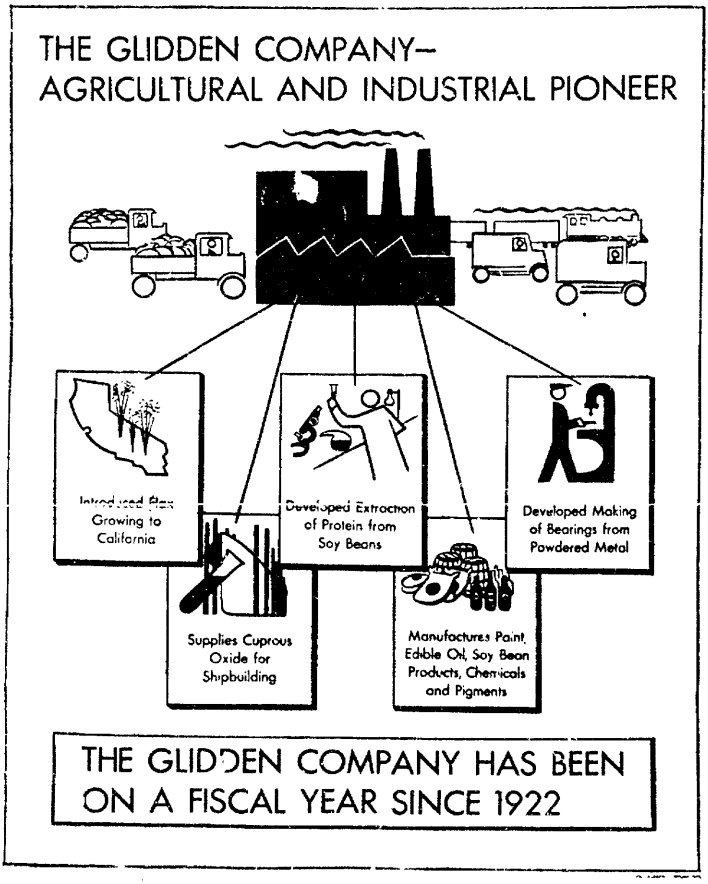

THE GLIDDEN COMPANY–
AGRICULTURAL AND INDUSTRIAL PIONEER
Introduced Flax Growing to California
Developed Extraction of Protein from Soy Beans
Developed Making of Bearings from Powdered Metal
Supplies Cuprous Oxide for Shipbuilding
Manufactures Paint, Edible Oil, Soy Bean Products, Chemicals and Pigments
THE GLIDDEN COMPANY HAS BEEN ON A FISCAL YEAR SINCE 1922

CHART NO. 2

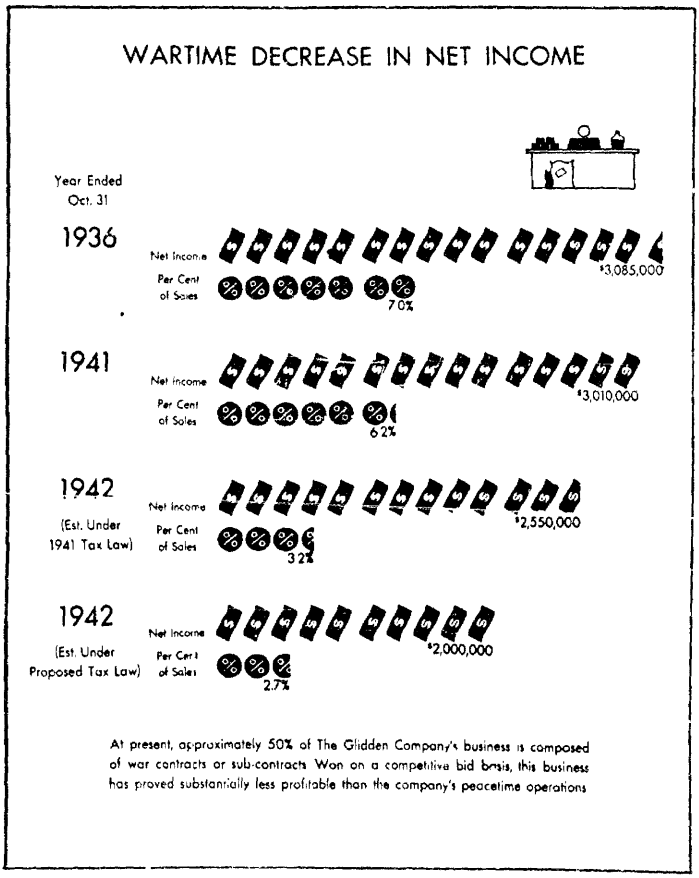

WARTIME DECREASE IN NET INCOME
Year Ended Oct. 31
1936
Net Income
Per Cent of Sales
$3,085,000
7.0%
1941
Net Income
Per Cent of Sales
$3,010,000
6.2%
1942
(Est. Under 1941 Tax Law)
Net Income
Per Cent of Sales
$2,550,000
3.2%
1942
(Est. Under Proposed Tax Law)
Net Income
Per Cent of Sales
$2,000,000
2.7%
At present, approximately 50% of The Glidden Company's business is composed of war contracts or sub-contracts. Won on a competitive bid basis, this business has proved substantially less profitable than the company's peacetime operations

CHART No. 3

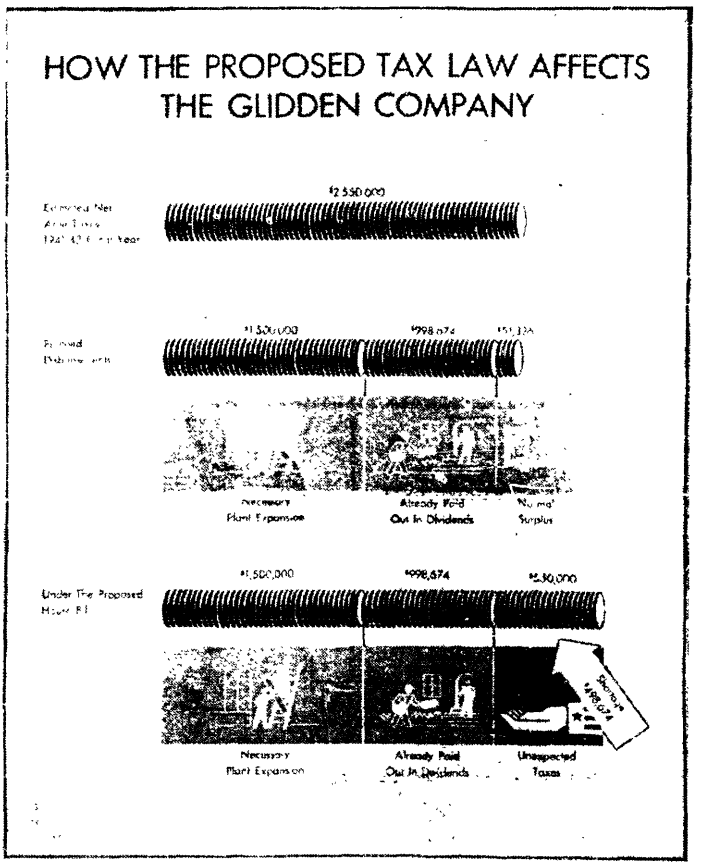

HOW THE PROPOSED TAX LAW AFFECTS THE GLIDDEN COMPANY
$2,550,000
$1,500,000
$998,674
Necessary Plant Expansion
Already Paid Out In Dividends
Normal Surplus
$1,500,000
$998,674
$50,000
Necessary Plant Expansion
Already Paid Out In Dividends
Unexpected Taxes
Dividends $998,674

CHART NO. 4

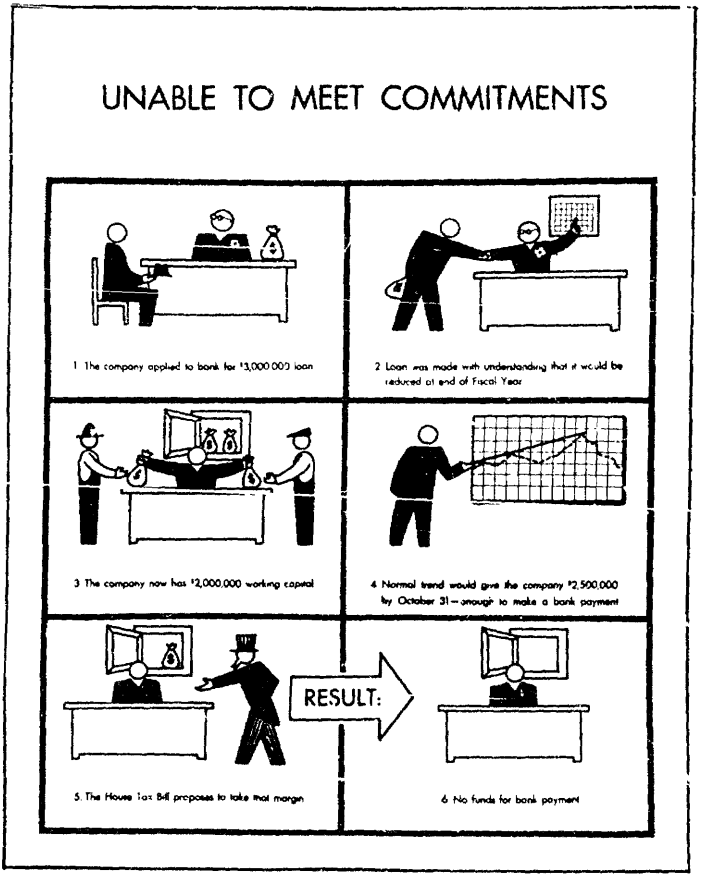
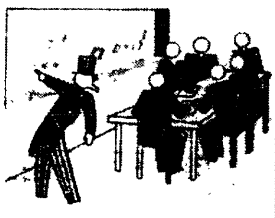

UNABLE TO MEET COMMITMENTS
1. The company applied to bank for $3,000,000 loan
2. Loan was made with understanding that it would be reduced at end of Fiscal Year
3. The company now has $2,000,000 working capital
4. Normal trend would give the company $2,500,000 by October 31—enough to make a bank payment
5. The House Tax Bill proposes to take that margin
RESULT:
6. No funds for bank payment

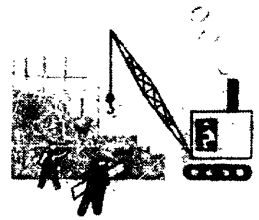
CHART NO. 5

THE STORY OF COMPANY L (PART I)

(FISCAL YEAR ENDS NOV. 30)



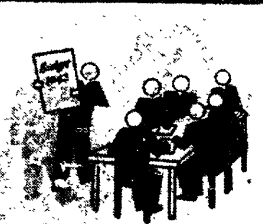
In 1938, with many unemployed, the Government urged expansion of business.



Company L decided it was a sound and patriotic time to build a new plant.



Plant finished July 1, 1941. Company L borrowed $1,175,000 to complete payment.



Company L's 1942 Budget, carefully planned, including a $500,000 repayment of loan... on the basis of the 1941 tax law

CHART No. 6

THE STORY OF COMPANY L (PART II)

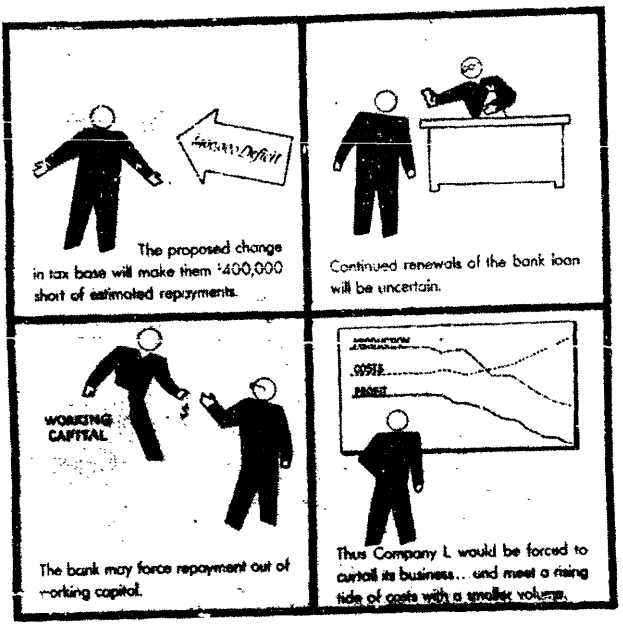


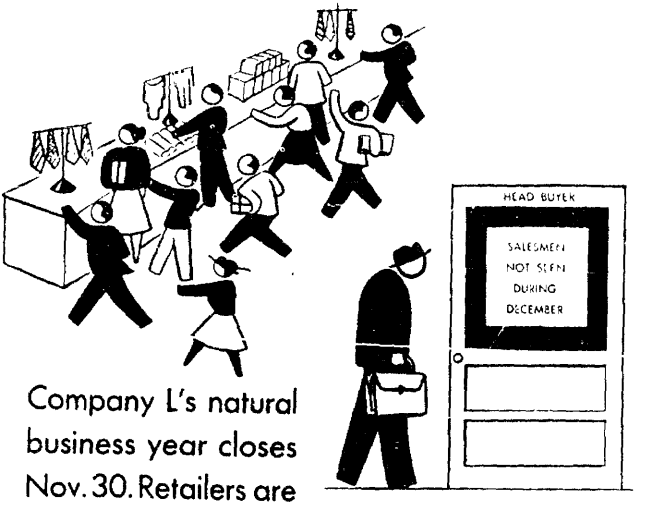
CHART NO. 7

SINCE 1934, the Treasury Department has eliminated confusion by advocating that the Revenue Act of any year be applied only to a fiscal year beginning in the year of the Act...Will we now return to the former confusion?



CHART No. 8

WHY DO COMPANIES USE THE FISCAL YEAR?

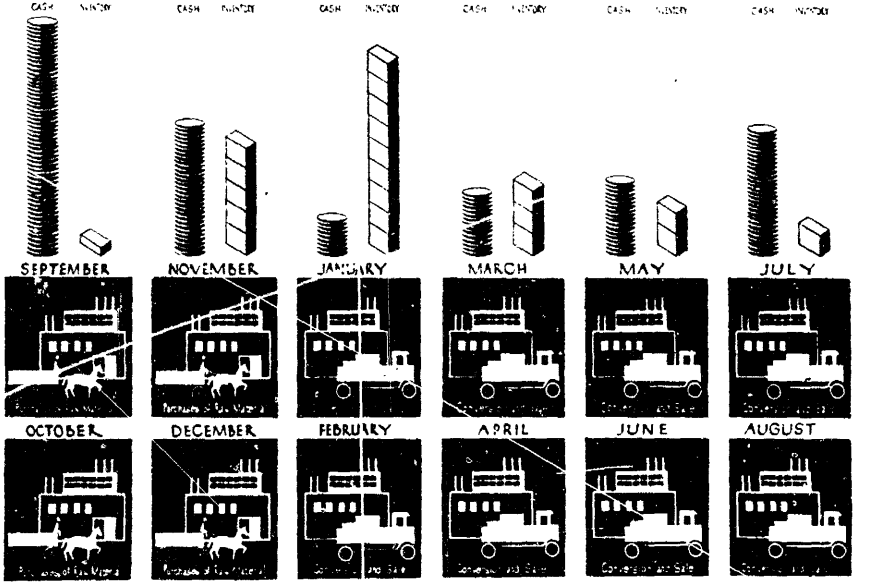


Company L's natural business year closes Nov. 30. Retailers are too busy in December to see Company L's men or send in orders. Their cycle of buying raw materials, manufacturing and selling ends in Nov.

CHART NO. 9

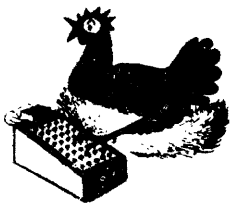
THE SPENCER KELLOGG COMPANY'S FISCAL YEAR

(As per Report No. 5 of your hearings)



REVENUE ACT OF 1942
1019

CHART No. 10



Spencer Kellogg's testimony shows that applying the calendar year to a company whose business cycle ends at another period makes an annual statement worse than "Counting your chickens before they hatch." It is pure crystal gazing.

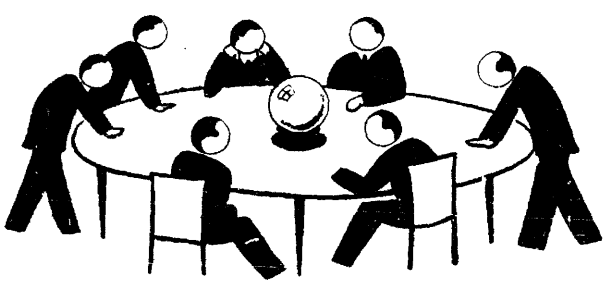


CHART No. 11

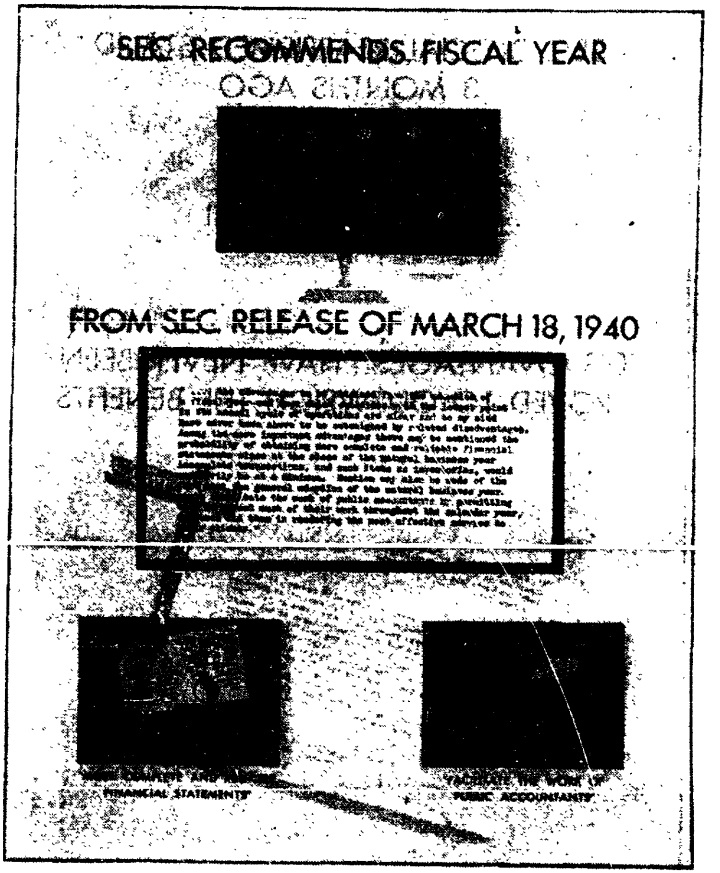
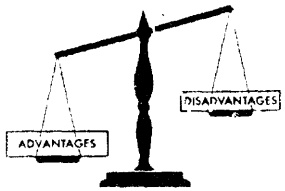

SEC RECOMMENDS FISCAL YEAR
FROM SEC RELEASE OF MARCH 18, 1940
FINANCIAL STATEMENTS
PUBLIC ACCOUNTANTS

CHART No. 12

SEC. OFFICIAL REAFFIRMED STAND 3 MONTHS AGO



"DISADVANTAGES...HAVE NEVER BEEN PROVED TO OUTWEIGH THE BENEFITS"

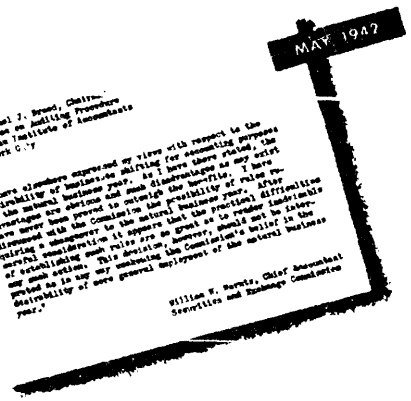


CHART No. 13

I AM RECOMMENDING A CHANGE IN THE HOUSE BILL...

NOT because it injures our company alone...

BUT because hundreds of companies—

in various industries ...some of them vital to the war



WILL SUFFER IN MANY WAYS

for example

CHART No. 14

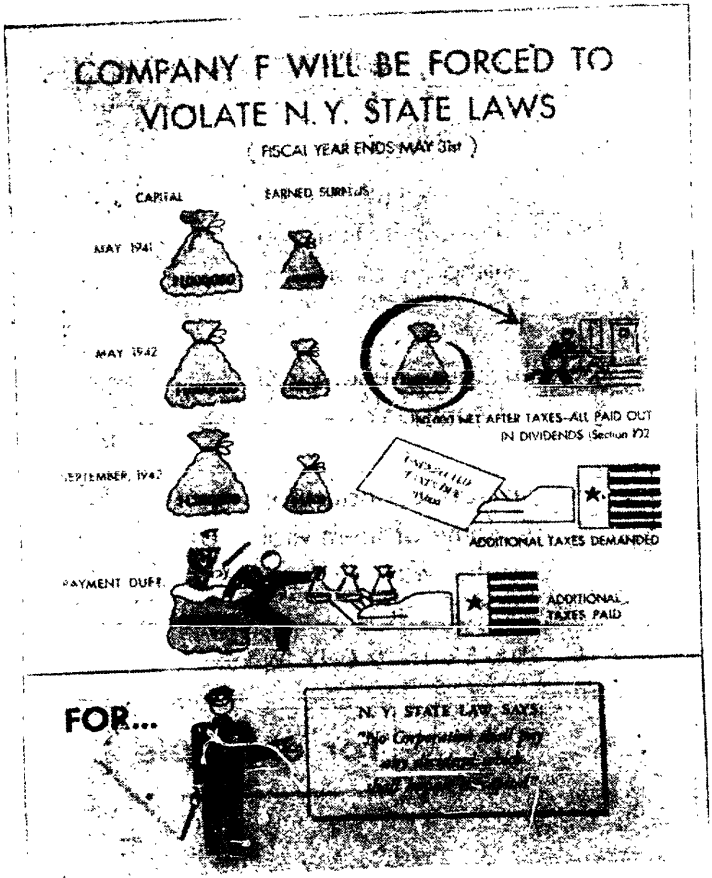

COMPANY F WILL BE FORCED TO VIOLATE N. Y. STATE LAWS
(FISCAL YEAR ENDS MAY 31st)
CAPITAL
EARNED SURPLUS
MAY 1941
MAY 1942
NET AFTER TAXES—ALL PAID OUT IN DIVIDENDS (Section 102
SEPTEMBER, 1942
ADDITIONAL TAXES DEMANDED
PAYMENT DUE
ADDITIONAL TAXES PAID
FOR...
N. Y. STATE LAW SAYS:

CHART No. 15

COMPANY C WILL BE KEPT FROM MEETING COMMITMENT MADE IN GOOD FAITH

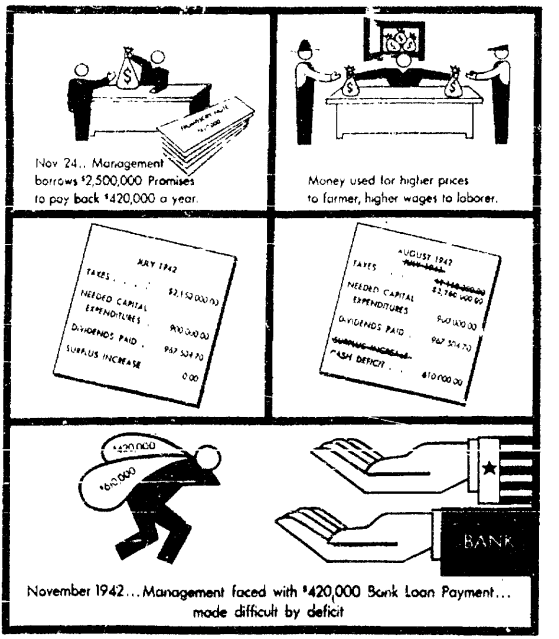


CHART No. 16

THE ADMINISTRATION SAYS:

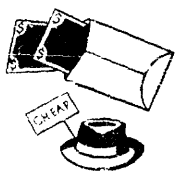
To avoid depressions we must maintain full employment.



☆ ☆ ☆

TO HAVE FULL EMPLOYMENT WE MUST:

1·MAINTAIN HIGH WAGES... to put purchasing power into hands of many.



2·MAINTAIN LOW PRICES... so more people can buy

3·ACCEPT THE FACT THAT 1 and 2 PRODUCE SMALLER PROFITS to wealthy corporations or owners who do not use large profits to buy more hats, shirts or radios.



BUT

small profits and reduced surpluses make it impossible for such corporations to meet unexpected demands such as this tax.

CHART No. 47



WHAT WOULD BE
THE EFFECT OF A FISCAL
YEAR CHANGE ON
AN ACTUAL COMPANY
THAT FITS THE
ADMINISTRATION'S
PATTERN?

CHART No. 18 A

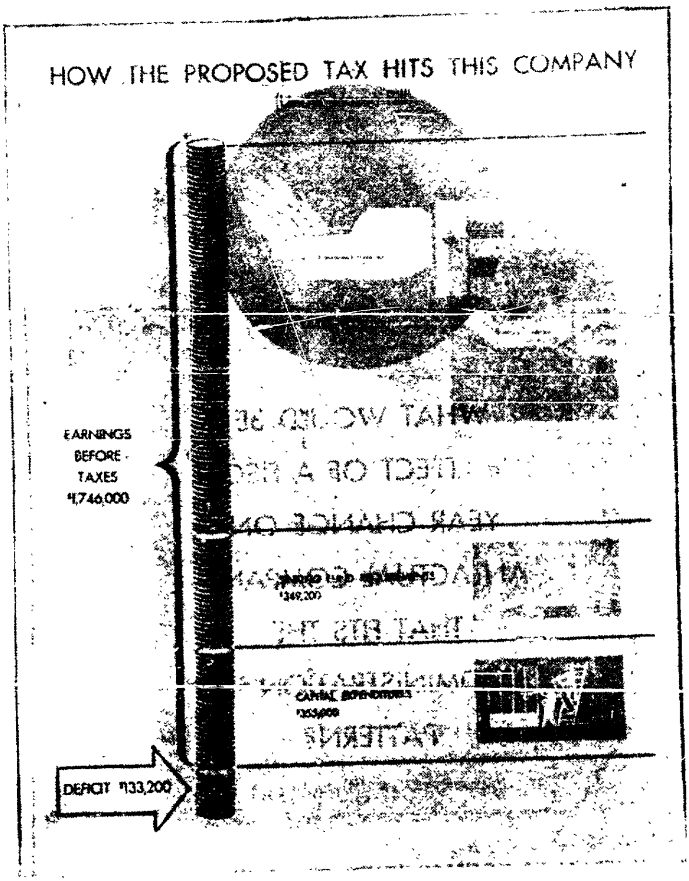

HOW THE PROPOSED TAX HITS THIS COMPANY
EARNINGS BEFORE TAXES $1,746,000
DEFICIT $133,200

CHART No. 18 B

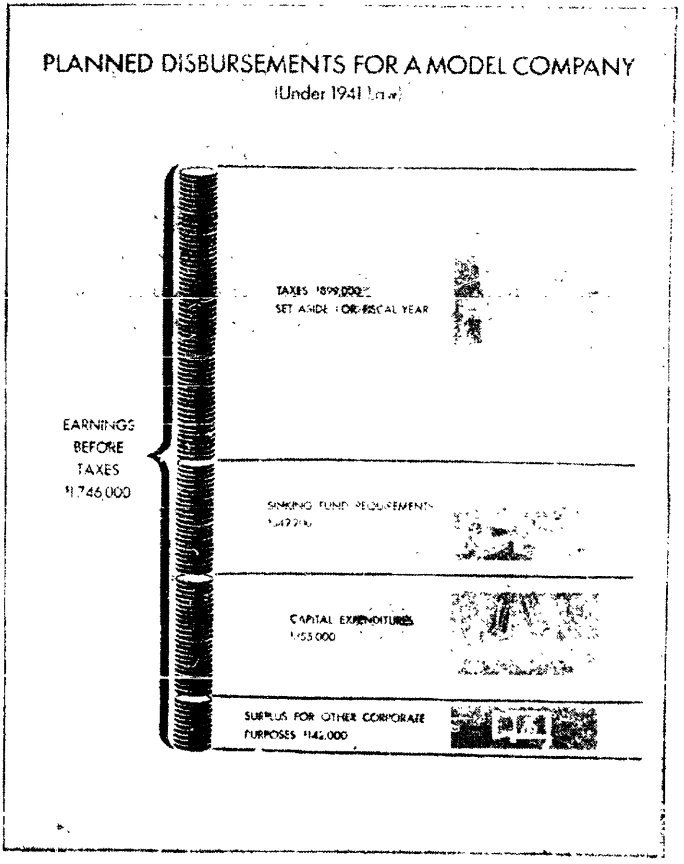
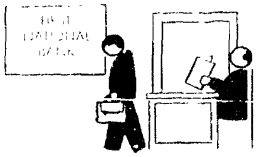

PLANNED DISBURSEMENTS FOR A MODEL COMPANY
(Under 1941 Law)
EARNINGS BEFORE TAXES $1,746,000
TAXES $899,000
SET ASIDE FOR FISCAL YEAR
SINKING FUND REQUIREMENTS
$422,000
CAPITAL EXPENDITURES
$153,000
SURPLUS FOR OTHER CORPORATE PURPOSES $141,000

CHART No. 19

WITH SUCH A DEFICIT...HOW WILL THE UNEXPECTED TAX BE PAID?

WITH A BANK LOAN?



Such a company must sail close to the wind, and cannot get additional loans from the bank

FROM THE GOVERNMENT?



What good would it do Uncle Sam to loan $133,200 with one hand and take it back with the other?

CHART NO. 20

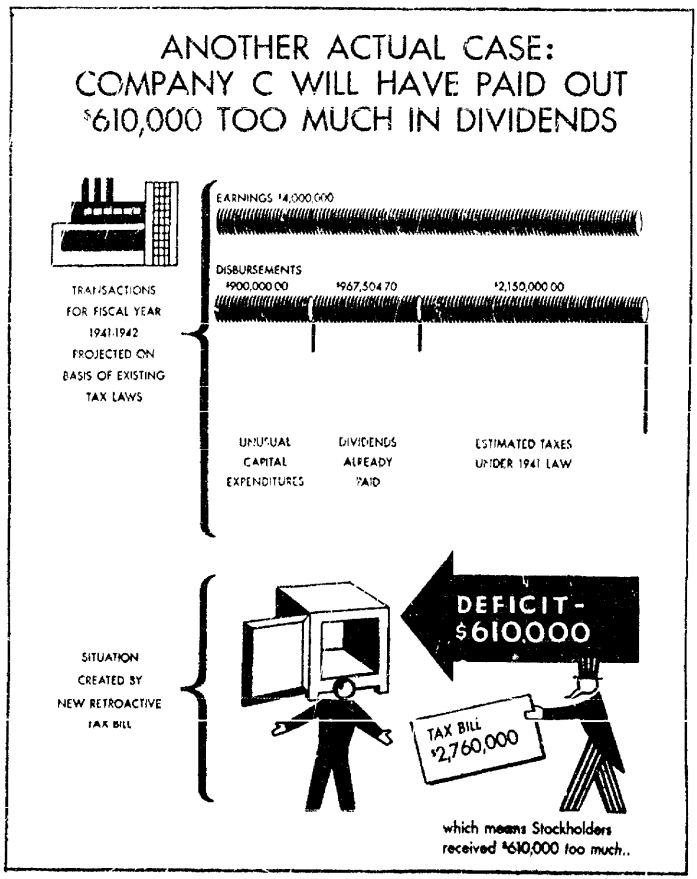

ANOTHER ACTUAL CASE:
COMPANY C WILL HAVE PAID OUT
$610,000 TOO MUCH IN DIVIDENDS
EARNINGS $4,000,000
DISBURSEMENTS
$900,000.00
$967,504.70
$2,150,000.00
TRANSACTIONS FOR FISCAL YEAR 1941-1942 PROJECTED ON BASIS OF EXISTING TAX LAWS
UNUSUAL CAPITAL EXPENDITURES
DIVIDENDS ALREADY PAID
ESTIMATED TAXES UNDER 1941 LAW
SITUATION CREATED BY NEW RETROACTIVE TAX BILL
DEFICIT - $610,000
TAX BILL $2,760,000
which means Stockholders received $610,000 too much..

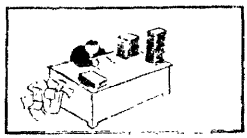
CHART No. 21



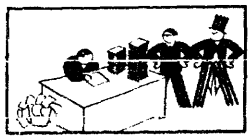
CHART No. 22

THE PROPOSED CHANGE WOULD CAUSE VARIOUS KINDS OF CONFUSION IN:

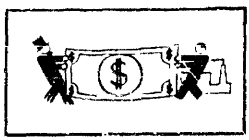
1. Accounting



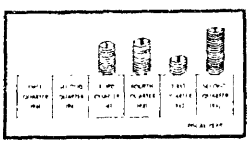
2. Making Required Official Reports



3. Treatment of Capital Gains



4. Treatment of Gains in one calendar year and Losses in another



5. INTERPRETING THE BILL

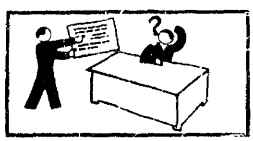


CHART No. 23

CONFUSION NO. 1

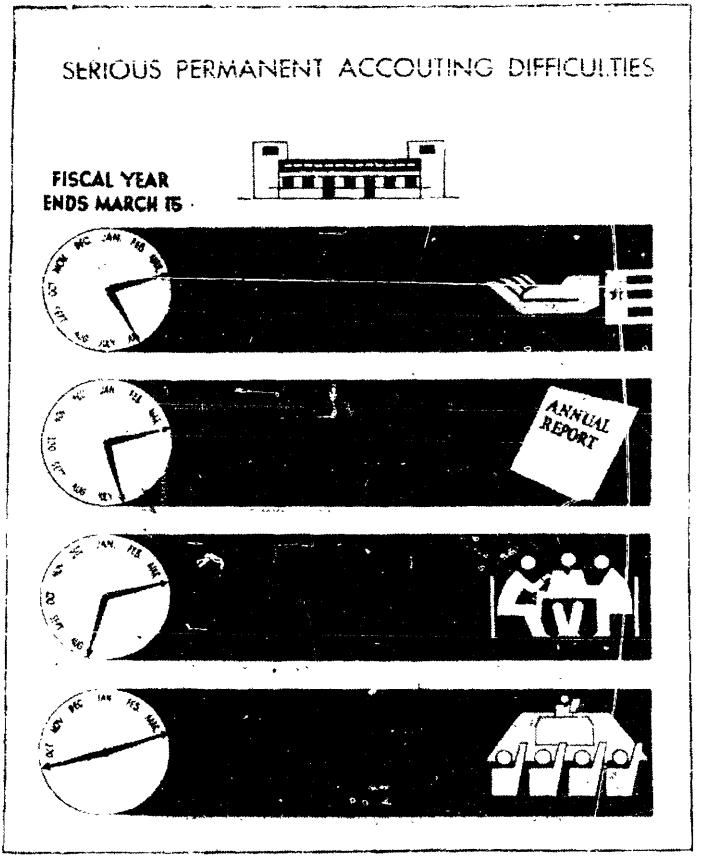


CHART No. 21

CONFUSION NO. 2

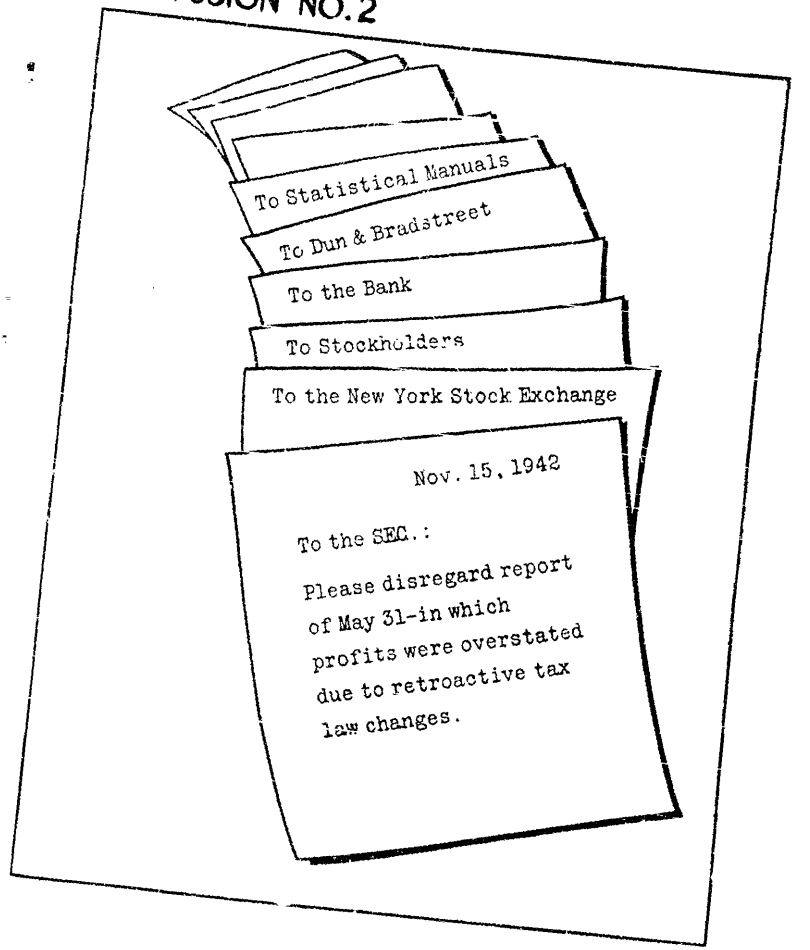


CHART NO. 25



CHART No. 26

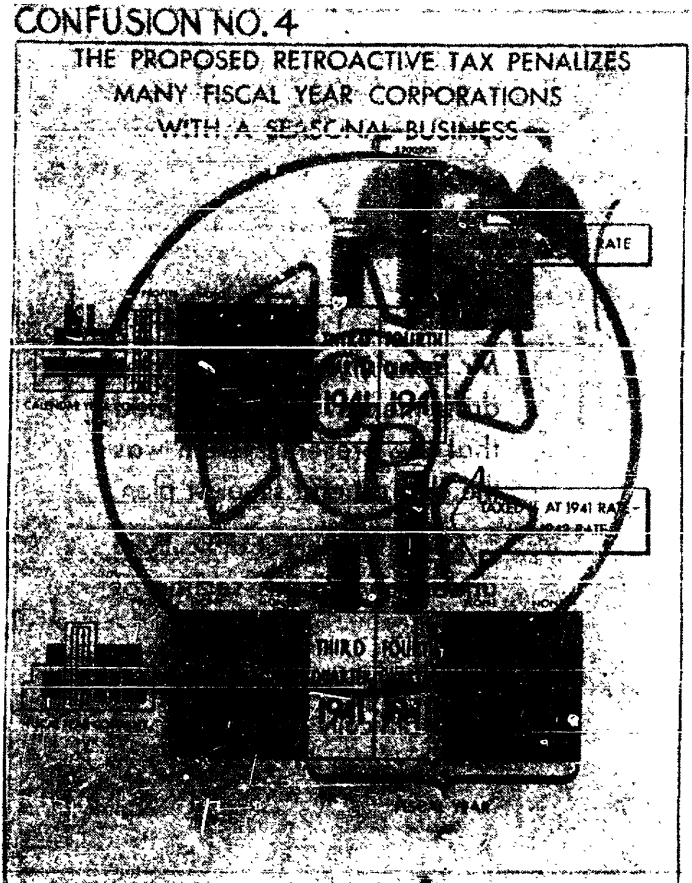
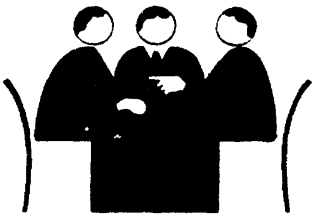

CONFUSION NO. 4
THE PROPOSED RETROACTIVE TAX PENALIZES
MANY FISCAL YEAR CORPORATIONS
WITH A SEASONAL BUSINESS
AT 1941 RATE
THIRD

CHART NO. 27



IN 1934...

Mr. Beeman and other expert draftsmen evidently decided that the present system was the clearest and simplest plan.

I have had great difficulty in understanding this section of the bill...

MOST tax payers will have the same difficulty

AND...

CHART No. 28

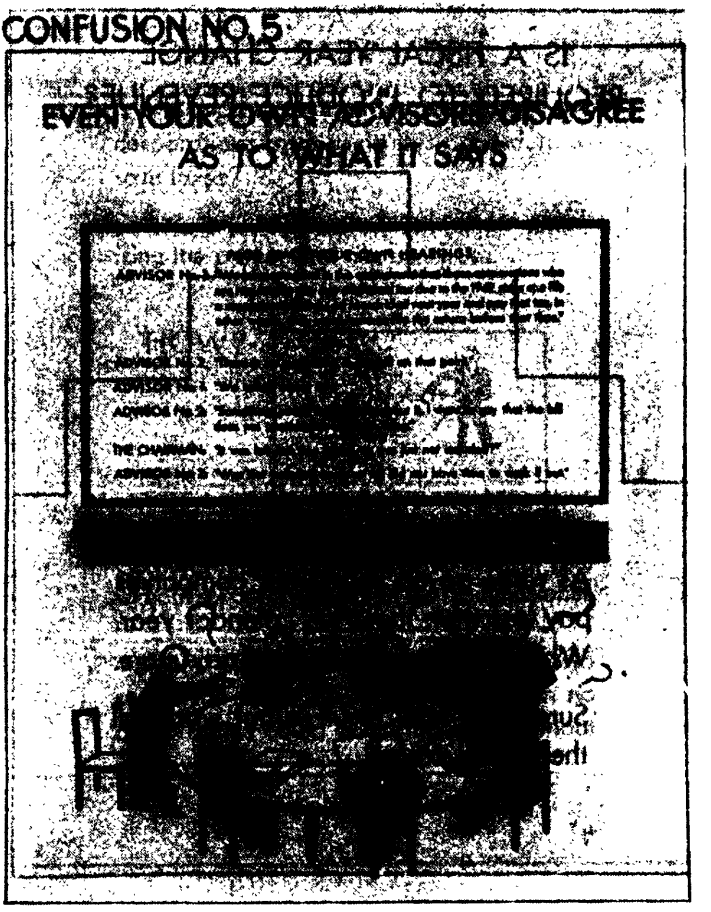

CONFUSION NO. 5
EVEN YOUR OWN ADVISERS DISAGREE
AS TO WHAT IT SAYS

CHART No. 29

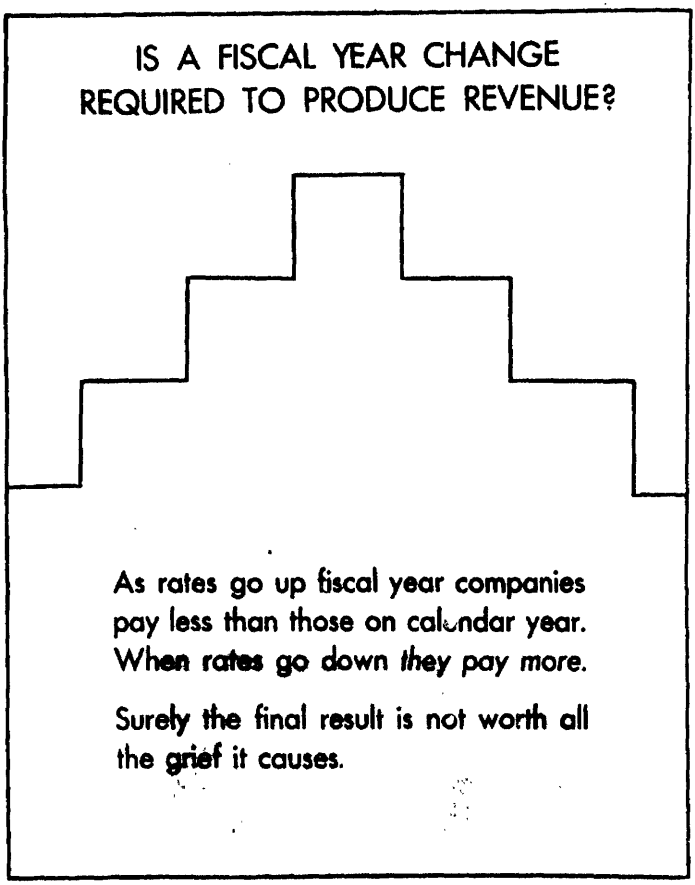
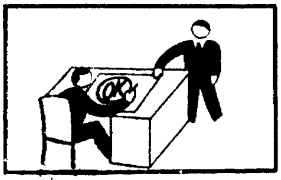

IS A FISCAL YEAR CHANGE
REQUIRED TO PRODUCE REVENUE?
As rates go up fiscal year companies pay less than those on calendar year. When rates go down they pay more.
Surely the final result is not worth all the grief it causes.

CHART No. 30

Is a fiscal year change required to prevent corporations from using this procedure to save taxes?

If so, this can be prevented without penalizing the proper and necessary use.

HOW?



Corporations cannot change to a fiscal year without securing consent of the Commissioner.

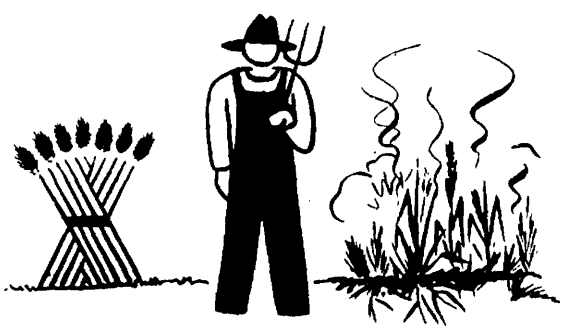
If new corporations are also required to secure the Commissioner's consent, then no corporations could select this basis without approval of the Treasury.

CHART No. 31

THERE ARE TWO WAYS TO PREVENT MISUSE:

1. The hard way—to endeavor to punish the guilty ones only.

2. The easy way—to punish all who use the fiscal year—good and bad alike.



WHEAT TARES

CHART NO. 32

When someone in Lidice killed a member of the Gestapo, a Gestapo agent reported to the commander that it would be difficult to find the guilty party. He nonchalantly replied:

"Ach, just kill them all."

They took the easy way out and shot every man in the village.

I believe that this Committee can find a way to prevent the improper use of the Fiscal Year basis without punishing the innocent along with the guilty.

The CHAIRMAN. Mr. Greeley.
(No response.)
The CHAIRMAN. Mr. Batchelder.

STATEMENT OF K. C. BATCHELDER, SEATTLE, WASH., TRAFFIC MANAGER, WEST COAST LUMBERMEN'S ASSOCIATION

The CHAIRMAN. I understand that it has been agreed by your group that you would proceed, you would come first?

Mr. BATCHELDER. Yes, sir. We got together, as you suggested, and have condensed our presentation.

The CHAIRMAN. We certainly appreciate that.

Mr. BATCHELDER. My name is K. C. Batchelder. I am traffic manager of the West Coast Lumbermen's Association, at Seattle, Wash. I appear for the association to oppose the tax on transportation of property as it would be applied to lumber by section 621 of the House bill.

The West Coast Lumbermen's Association is an organization of 219 loggers and lumber manufacturers. It represents 80 percent of the lumber production in western Oregon and Washington, which produces one-third of the softwood lumber in the United States. More than 70,000 employees are dependent upon our lumber industry for their livelihood. What corn is to Iowa, cotton to the South, timber is to the Pacific Northwest; 65 percent of the industrial pay rolls of the region springs from this industry.

West coast lumbermen oppose the transportation tax because it discriminates against the long-haul shipper in favor of the short-haul shipper. It places a heavier burden upon the distant supplier of any market than upon the supplier close at hand; and thus disrupts their present competition to the disadvantage of the former.

We hold that this tax in the form proposed would discriminate against and penalize all the basic resources of the West which move to central and eastern markets. Oregon lumber marketed in New York City would pay double the tax per thousand feet on lumber produced in Alabama and treble the tax on lumber produced in Maine.

We are ready to carry our part of war taxes. But we ask that, if Congress deems a tax on transportation necessary, its discriminatory feature be avoided.

In the case of lumber for example, a flat tax of 2 cents per hundred pounds would treat all shippers alike and give the Government a higher return than the 5 percent provided in the House bill. The House applied this principle to the taxation of coal shipments. We believe it is just as essential in the case of lumber shipment.

The west coast lumber industry has been handicapped from the outset by its great distance from most of the larger industrial and building markets of the United States. The average length of haul for west-coast lumber in 1941 was 1,829 miles. This compares with 201.9 miles, the average haul on all freight for the Nation in 1939.

I have a set of exhibits here. On page 1 of these exhibits we show that 50 percent of the west-coast lumber moved to eastern territory during the first 5 months of 1942. Is there any reason why a car of lumber from the west coast should pay a higher tax than a car of

lumber from any other region? It is the view of the industry that any tax that is not equal in its effect upon all citizens is discriminatory and should not be approved.

From latest available figures of the Interstate Commerce Commission, the percent of transportation cost to value at origin is for all commodities 9.22.

This is shown on page 2 of our exhibit.

For the products of forests, it is 15.98 percent. For all grades of west coast lumber it is 67.2 percent, seven times greater than the national average for all commodities, four times greater than the national average for forest products. The tabulation, page 3, reflects the particular burden on construction grades of our lumber which constitute more than 78 percent of production.

On No. 1 grade, transportation cost is 74 percent of mill value, and ranges to 119 percent for No. 3, a higher charge for transportation than the value of the products at the mill. This lumber will not stand a tax any greater than that imposed on competing lumber.

Just stop for a moment, gentlemen, and consider that the transportation tax proposed in Section 621 of this bill would be levied against 40 percent of the delivered value of all west coast lumber shipped east of the Mississippi River; and against 48 percent of the low grades of west coast lumber, No. 2 and No. 3. The lower the grades of lumber, the heavier the tax in relation to delivered value.

This tax would make it still harder to utilize the low-grade logs in northwestern forests. It would work against forest conservation. We maintain that it is not only discriminatory as between shippers, but contrary to the public interest.

The chart, page 4, shows the progressive additional freight paid by west coast lumber compared to its principal competitor to a typical eastern destination—Detroit, Mich., on group D lumber.

On June 24, 1918, the heavy black line shows added freight for lumber from the West to be 34.8 cents per hundredweight. Today the difference has increased to 52 cents per hundredweight. An ordinary 2 by 4 weighs in the neighborhood of 2,500 pounds per thousand feet. On this weight, our competitor pays $10.75 in freight charges; the West $23.75—$13 per thousand feet more from the West.

The last column on the graph shows what the addition of a 5 percent tax would do to western lumber as compared with the South.

It would add 2.2 cents per hundredweight to the southern lumber rate; 4.8 cents to the western. This means the western tax would be 2.6 cents per hundredweight greater than from the South, or nearly 50 cents per thousand feet of lumber.

The alternate rate applying to this territory is charted on page 5. Supporting rate history for the chart, as well as history and spreads to additional destinations, is tabulated on pages 6 to 10.

The Interstate Commerce Commission reported in 1941, for freight commodity classifications 430 and 431, 33,000,000 tons. This is shown on page 11 of the exhibit. Total revenue was $23,682,743.

Applying the 6-percent increase authorized by the Commission, this would increase the revenue to $245,583,708 for forest products. This is an average freight rate of 37.2 cents per hundredweight. A 5-percent tax on this rate would produce a flat increase in 1.86 cents per hundredweight, or $12,279,185.40. Lumber is a comparatively low-

grade commodity. A tax of 5 percent with a maximum of 2 cents per hundredweight is considered the most equitable tax.

As an alternate, a straight or flat tax of 2 cents per hundredweight will be acceptable. The latter tax would produce $13,219,122.40, or nearly $1,000,000 more than the percentage tax.

One phase of the bill I want to call particularly to your attention is that relating to business outside the United States, which reads:

> In the case of property transported from a point without the United States to a point within the United States, the tax shall apply to the amount paid within the United States for that part of the transportation which takes place within the United States.

Canadian sawmills located on the Pacific coast, in the Province of British Columbia, compete in all markets with lumber from Oregon and Washington.

If the above provision is adopted, it would be possible to route a car of lumber from Vancouver, British Columbia, to Boston, Mass., via the Canadian Pacific Railway, to Wells River, Vt., thence Boston & Maine Railroad. The distance transported in Canada is 2,975 miles, in the United States 245 miles, or 7.6 percent of the distance in the United States.

The American shipper in Portland, Oreg., would pay a tax on a 60,000-pound shipment at 87 cents per hundredweight—$25.10 per car.

The Canadian shipper would pay only 7 percent of that amount, or $1.81. Fourteen times more tax for the United States shipper.

The mill in Oregon and Washington is already greatly handicapped in competing with the Canadian mill because of the substantial additional cost of labor paid, a relatively higher cost of stumpage, plus an advantage of 10 percent due to Canadian exchange.

All shipments of lumber should be subjected to an equal tax, whether from within or without the borders of the United States.

I am president of the Pacific Northwest Advisory Board, an organization of 1,500 carload shippers of freight in Washington, Oregon, and Idaho. This group is opposed to a percentage increase in a tax on transportation charges. The Douglas Fir Plywood Association, Tacoma, Wash., and the California Redwood Association, San Francisco, Calif., have authorized me to say they join in this statement.

The Portland Traffic Association, Portland, Oreg., are opposed to the 5-percent tax.

Western Pine Association are also opposed. Mr. P. M. Crapo is here, but for lack of time, has filed a statement which he has asked me to call to your attention.

In conclusion I want to say that to avoid the imposition of a discriminatory tax, the interests which I am here representing are opposed to a percentage tax on freight charges; and propose that, if a tax on transportation is to be imposed, a maximum of 2 cents per hundredweight be applied on all lumber and articles taking lumber rates.

As an alternate, we suggest a flat tax of 2 cents per hundredweight on lumber and articles taking lumber rates.

The time you have allotted for this presentation is greatly appreciated; we trust you will give favorable consideration to the proposals made.

The CHAIRMAN. Thank you very much.

Mr. Crapo, for the Western Pine Association, has addressed a letter to the committee which he wished to have incorporated in the record at this point.

(The letter from Mr. Crapo is as follows:)

WESTERN PINE ASSOCIATION,
Portland, Oreg., August 6, 1942.

The CHAIRMAN,
Senate Finance Committee, Washington, D. C.

SIR: The Western Pine Association, of Portland, Oreg., is an association of lumber manufacturers in the States of Arizona, California, Colorado, Idaho, Montana, New Mexico, Oregon, South Dakota, Washington, and Wyoming. The Western Pine Association is a trade association similar to others representing lumbermen in different producing regions and has for its purpose the general welfare of its members, including such activities as the standardization of grades, research and promotion of the species produced, compilation of statistics, traffic service, etc. In the year 1941 its members cut and shipped approximately 6,000,000,000 feet of lumber, or approximately 20 percent of the total national production of lumber.

We oppose a tax upon our transportation charges, for the following three reasons:

1. Transportation charges are a large part of the delivered price of lumber, especially lumber moving to long-haul competitive markets. In support of this statement we point to the fact that on lumber shipped from our members' mills to points east of the Rocky Mountains the transportation cost per thousand board feet ranges on an average of from 30 percent to 40 percent of the delivered price. It costs a lot of money to ship lumber from the west coast to the eastern markets. To points east of the Illinois-Indiana State line, we ship on an 87 cents per 100 pounds rate. The minimum weight for a 40-foot car is 50,000 pounds and for a 50-foot car 60,000 pounds. That means a freight charge of at least $435 for 40-foot cars and $522 for the 50-foot carloads. A 5-percent tax on the 40-foot loads will be at least $21.75 per car and on the 50-foot loads at least $26.10 per car. These taxes are all out of proportion to the tax that will be assessed on traffic moving short distances. This kind of tax is vicious, in that it discriminates against the shipper who is located some distance from his market. Sales taxes should be uniform in application and should not vary with the distance an article is transported.

2. Our second reason for opposing this tax is that freight rates on forest products have been already increased 6 percent this year (*I. C. C. Ex Parte 148*, March 18, 1942) upon authorization of the Interstate Commerce Commission. To impose a transportation tax of 5 percent will result in a total increase this year of 11.3 percent in our rates. The continual increasing of freight rates on a percentage basis is making it more and more difficult for us to sell our lumber in competition with lumber and lumber substitutes produced nearer the market. Before World War No. 1 we used to ship our lumber from the west coast to Chicago on a 55-cent rate as compared with a 26½-cent rate from Mississippi. The spread in rates between the two regions at that time was 28½ cents per 100 pounds. Our rate today is 80 cents, while the rate from Mississippi is 42 cents, the spread now being 38 cents. Under the proposed 5-percent tax the spread will become 40 cents. What with the much higher wage scales paid in the Pacific Coast territory and the rate handicap we must overcome, we do not relish the prospects of having our rate handicap increased again.

3. Our third reason for opposing the transportation tax is that the proposed tax will be much greater on our lumber which is produced in the Intermountain and Pacific Coast States than on lumber produced by our competitors in regions lying closer to the large consuming markets.

Most of the lumber produced in this country is consumed in the States east of the Missouri River and north of the Ohio and Potomac Rivers. Seventy percent of the population live in that area. Freight rates on lumber from the Southern States to this area are on an average about 50 percent of the lumber rates applying from the Pacific Coast States. It is obvious, therefore, that our lumber would be taxed double the amount paid by the southern lumber. This is unjust discrimination. Why should our lumber be obliged to stand twice as much tax as lumber of the same grade produced in a different part of the

country? Why should the amount of the tax increase according to the distance the commodity is transported? The longer the haul the higher the rate. The higher the rate the more difficult it becomes to compete. So why increase the existing handicap of moving goods over longer distances? The lumber which moves the shortest distance, paying the lowest rate, is in the best position to pay the higher tax. This proposal taxes the product most, which is least able to pay its way. If your committee decides to recommend a tax on transportation, we ask that you give consideration to a maximum tax per unit of shipment, so as to equalize the competitive handicaps of long-haul shippers.

As far as lumber is concerned, we suggest that the maximum charge for any one carload be held to $10. That is assuming that the basic tax rate of 5 percent be retained. The $10 charge will be approximately the amount of tax that will be collected on a car of lumber moving from the south to Chicago, Ill., the freight rate on lumber to Chicago being 42 cents from Hattiesburg, Miss. In the event this suggestion is not to your liking, we suggest further that a maximum tax of 2 cents per 100 pounds be recommended to apply on lumber and articles listed in tariffs, as and when taking lumber rates, carloads. The 2-cent maximum will be the amount in cents per 100 pounds that will be assessed on southern lumber to Chicago (5 percent of 42 cents equals 2 cents).

Respectfully submitted.

P. M. CRAPO,
For Western Pine Association.

The CHAIRMAN. Mr. Shafer?

STATEMENT OF GEORGE SHAFER, ST. PAUL, MINN., REPRESENTING THE WEYERHAEUSER SALES CO.

Mr. SHAFER. Mr. Chairman, members of the committee, I represent the Weyerhaeuser Sales Co. as general traffic manager.

We have large lumber-producing mills in the States of Idaho, Oregon, and Washington.

We also produce and ship from those States, particularly the State of Washington, wood pulp to the eastern market in competition with wood pulp from the South, Southwest, and New England.

We are members of the West Coast Lumberman's Association and the Western Pine Association.

Our products, like the products of all the members of those two associations, move great distances to the eastern markets.

We have, prior to the first of this year, been able in a measure to meet the competitive situation in the Eastern States by use of the intercoastal transportation.

Our own company had in service eight boats operating through the Panama Canal.

Those boats we very gladly gave over to the war effort, and they are now operating under the jurisdiction of the Maritime Commission.

It has denied us the opportunity to get our products on lower freight rates into this territory. We are now paying the higher rail transportation charges, and the effect of this tax would be to increase those transportation charges by an additional 5 percent.

The House committee submits this bill to the House with this statement:

> During the World War a tax was imposed upon transportation of property by freight at the rate of 3 percent—

without any further explanation.

I call your attention to the fact that the situation during the last war was quite different than it is today. We did not at that time have the price ceilings to contend with that we have now, and the tax was 3 percent not 5 percent as they here propose.

Furthermore, the freight rate situation was quite different.

For instance, the rate on lumber from Seattle to Chicago in 1918 was 55 cents per hundred pounds, whereas in 1942 the rate is 80 cents per hundred pounds.

The rate to New York at that time was 75 cents and today the normal lumber rate all-rail to New York City is $1 per hundred pounds.

So you can see a vast difference between 3 percent then and 5 percent now.

Another point that I should like to call to your attention is the proposal in the House bill on coal, of 5 cents per ton, a flat rate per ton, which is ample precedent for the proposal we bring to you here.

I should, in that connection—while we are not opposing the coal proposal, you understand—I should like to call attention to the fact that 5 cents per ton amounts to about 2½ percent on the average movement of coal and not 5 percent.

Senator VANDENBERG. What would be an equivalent flat tax on lumber?

Mr. SHAFER. A 2½-percent tax on lumber, on the average freight moved within the United States, as supported by the figures of the Interstate Commerce Commission, would produce something less than 1 cent per hundred pounds.

First, we do not necessarily favor a tax on transportation charges. It is not necessarily a proper taxable service. But if there must be a tax equal to 5 percent—we realize this committee must find revenue for this war effort—if in your wisdom you believe that there must be a tax, we suggest that it be a flat 2 cents per hundred pounds, or, in the alternative, a 5-percent tax with a maximum of 2 cents per hundred pounds to more nearly protect the long-haul shipper with high rates.

In other words, it is not, I believe, that you are trying to lay a heavier burden on one producer of a commodity than you are on another—you are not trying to impose a discriminatory tax—and, therefore, our suggestion.

We also call your attention to the fact that a 5-percent tax, as proposed, would levy a tax on sawlogs which move to the mill, and another 5-percent tax on the lumber as it moves out, and it would be pyramided on down to the ultimate consumer.

I should like now to call your attention to a communication that has been addressed to your chairman by Shevelin, Carpenter & Clark Co., which contains some figures of great interest upon which we collaborated. I think each member of the committee has a copy of this letter. To avoid repetition, I shall now give over my time to someone else.

The CHAIRMAN. Thank you.

Senator BROWN. It is necessary for me to leave the committee at this time.

I made some observations yesterday in regard to a plan to meet this problem that disturbs corporations and individuals whose in-

debtedness is such that it cannot be met with Federal taxes, and I merely ask that this statement be printed in the record so that the Treasury may give consideration to it.

It is a very short statement.

The CHAIRMAN. Yes, sir. You may do so. The reporter will include it in the record.

(The statement presented by Senator Brown for incorporation in the record is as follows:)

OBSERVATION ON PROPOSAL TO RELIEVE CORPORATIONS AND INDIVIDUALS WHO ARE COMMITTED ON PAYMENT OF DEBTS IN SUCH AMOUNTS AS CANNOT BE MET AFTER PAYMENT OF TAXES UNDER THE NEW TAX BILL, SUBMITTED BY SENATOR PRENTISS M. BROWN, OF MICHIGAN

There is merit in Senator Taft's suggestion for solution, but I fear his plan opens the way to considerable loss to the Treasury. It would seem to me that we might consider a practice already sanctioned by statute in a somewhat similar situation.

By section 3798 of the present law, which was an amendment to the 1939 act, made by this committee, we subordinated the claims of the Federal Government by way of taxes to the creditors of insolvent banks. In effect, we provided that no taxes could be collected against the receiver of an insolvent bank until the general depositor creditors were first paid in full. We then provided that if any balance remained, taxes could be assessed, levied, and collected against the remaining assets in the amount of the income taxes deferred or subordinated by the statute. The effect of the excessive tax rates on the class of corporations and individuals who desire relief is to render them either insolvent or temporarily so.

It would seem logical to subordinate Federal taxes to the debt commitments in such cases but not to cancel the Federal taxes if they may eventually be collected. Where taxes are an extreme burden upon estates, we have permitted a deferring of them for a period of as long as 10 years by section 822 of the Internal Revenue Code, and we have reduced the exorbitant 6 percent interest rate to 4 percent. It was the best we could get at the time. Following this practice, we might provide for a deferring of these taxes subordinated to debt payments and consider a lower rate of interest on the outstanding obligation.

This plan would entirely eliminate the charge of unfairness as between the thrifty taxpayer who is not in debt and the taxpayer who is in debt. It is also possible that in many cases the Reconstruction Finance Corporation could take pressing obligations that are reasonably secured and defer their payment, thus taking corporations out of the class it is desired to relieve.

I think consideration also might be given as to whether or not under certain circumstances a moratorium might be granted to a taxpayer as against a creditor.

The CHAIRMAN. Mr. W. B. Greeley, of Seattle.

Mr. BATCHELDER. Mr. Greeley is not here, Mr. Chairman.

The CHAIRMAN. Mr. Hamley?

STATEMENT OF FREDERICK G. HAMLEY, OLYMPIA, WASH., DIRECTOR, WASHINGTON STATE DEPARTMENT OF PUBLIC SERVICE

Mr. HAMLEY. If I may be permitted, I should like to file in the record a number of statements that have been placed in my hands from a number of shipping associations in the West, and I will be able to make my statement rather brief.

The CHAIRMAN. Yes, sir. You may do so.

(The documents presented by Mr. Hamley for incorporation in the record are as follows:)

STATEMENT OF [illegible]
IN THE FEDERAL [illegible]
BUREAU [illegible]

To the United States [illegible]

HONORABLE SIRS: We [illegible]
passed the House of [illegible]
of 5 percent [illegible]
a tax as it is extremely [illegible]
a long haul to [illegible]
the war. We [illegible]
canned vegetables [illegible]

In normal times we [illegible]
wheat either in the [illegible]
outside of [illegible]. We [illegible]
normally produces [illegible]
and Atlantic [illegible]
all of these [illegible]
domestic [illegible]

We are [illegible]
fall haul from the [illegible]
to the Atlantic [illegible]. The [illegible]
weight before we [illegible]
Congress [illegible]
and the $1.61 [illegible]
which as [illegible]
we have been [illegible]
though we have a big [illegible]
pastry purposes.

We are advised by [illegible]
to New York under [illegible]
Midwest west of the [illegible]
pay only $2.14 [illegible]
the Pacific Northwest [illegible]
diners and [illegible]
the freight charges [illegible]
tax but virtually [illegible]

If a tax on transportation [illegible]
equitable between [illegible]
hundredweight which [illegible]
sections. We wish to enable [illegible]
Washington State Farm Bureau [illegible]
Growers League recognize the [illegible]
willing to accept [illegible]
your duty to tax every [illegible]
believe it is in the farmers' [illegible]
war as possible.

It is not our wish nor our purpose [illegible]
legislation. We do not [illegible]
section in any tax measure which [illegible]
commodities so that we will [illegible]
or a sack of potatoes [illegible]
of the country that [illegible]
should in [illegible]
domestic markets and [illegible]
sections. Especially is [illegible]
caused largely by the war [illegible]
our interstate [illegible]

Respectfully

[illegible]

MEMORANDUM BY NORTH PACIFIC MILLERS' ASSOCIATION, PORTLAND, OREG.

REASONS WHY OUR ASSOCIATION IS AGAINST THE 5-PERCENT TAX ON TRANSPORTATION CHARGES

The North Pacific Millers' Association membership is composed of 17 firms operating 25 flour mills in Washington, Oregon, and northern Idaho, with a daily capacity of 32,350 barrels of flour, 700 tons of commercial feeds, and 50 tons of cereals. Flour and cereals are sold and distributed by rail to all parts of this country. The eastern large consuming markets have taken a very substantial amount of flour for many years.

For many years we distributed to Atlantic and Gulf ports by steamer through the Panama Canal. Because of war conditions the Panama Canal service has been withdrawn. Until recently we could ship by rail to Duluth and other Lake Superior ports, thence by steamer to Buffalo, and thence by rail to destinations in the East. This service has been eliminated since the Government has taken over the steamers on the Great Lakes. We are now compelled to ship all rail.

The all-rail rates to the East are very high, and any additional charge that may be added to the present freight charges, if not properly related to the rates from other districts, would eliminate any of our flour reaching the eastern large consuming districts. As an example of this condition, we would like to submit the following comparison of rates, charges, and taxes, as proposed, basing our computations on a carload of flour or wheat weighing 80,000 pounds:

From—	To—	Rate	Charges	Tax
Spokane	Portland, Oreg	$0.26	$208	$10.40
Kansas City	Chicago, Ill	.16½	132	6.50
Minneapolis	do	.13½	108	5.40
Pacific Northwest	New York	1.00	800	40.00
Minneapolis	do	.40	320	16.00
Kansas City	do	.43	344	17.20
Pacific Northwest	Atlanta, Ga	1.09	872	43.60
Kansas City	do	.49	392	19.60

From the above it is readily ascertainable that the producer of wheat or the miller in the Pacific Northwest will pay $10.40 tax on his car of wheat or flour against the $5.40 tax on the car Minneapolis to Chicago, and $6.50 from Kansas City to Chicago.

On a car of flour or wheat shipped from the Pacific Northwest to New York the tax would be $40 as against $16 from Minneapolis and $17.20 from Kansas City, a difference of $24 and $22.80, respectively.

The wheat producers and the flour mills of the Pacific Northwest are now at a decided disadvantage over the wheat producers and flour millers of the Midwest because of the difference in the freight rates. For example, a car of either wheat or flour from the Pacific Northwest to New York is $800 for 80,000 pounds while from Minneapolis only $320, and from Kansas City $344. The differences range from $456 to $480 and are in favor of the Minneapolis and Kansas City shippers. These differences represent approximately $1 per barrel of flour and 27.5 cents per bushel of wheat. To add to the present disadvantages a tax on the percentage plan would widen these differentials the amount of the difference in the amount of the tax. This additional burden on wheat and flour from the Pacific Northwest would eliminate the sale of either wheat or flour in the eastern markets.

We are attaching an exhibit copied from a statement from the Surplus Marketing Administration, Marketing Division, Portland, Oreg., showing the amount of surplus wheat in the Pacific Northwest the 1st day of July this year. With over 53,000,000 bushels here now as a surplus, and with a bumper crop of approximately 97,000,000 bushels now being harvested, it should be evident that all present markets should be preserved.

Our mills are not opposing any tax that is necessary but are opposing the method of applying the tax. If a 5-percent tax is levied against all freight charges the producers of wheat and the millers using the wheat produced in the Pacific Northwest will have to pay more taxes than the producers and millers shipping shorter distances. It will not be an equal tax upon all. We do not believe Congress wants to tax those shipping longer distances more than they do those shipping shorter distances. If all shippers were to be taxed equally by a tax

in certain cents per hundred pounds regardless of distance a commodity is hauled or regardless of the amount of freight charges, then all markets would maintain their present relationships and no one would be injured.

Respectfully,

NORTH PACIFIC MILLERS' ASSOCIATION,
By R. D. LYTLE, *Secretary.*

Enclosure.

Analysis of 1941 wheat crop for Oregon, Washington, and northern Idaho, showing amount on hand July 1, 1942

	Bushels	Bushels
Carry-over July 1, 1941 (approximately)	20,000,000	
1941 crop, final estimate	92,975,000	
Received from Montana July 1, 1941, to June 30, 1942, (6,071 cars)	9,106,000	
Total wheat in stock		122,081,000
Disappearance July 1, 1941, to June 30, 1942:		
Feed	16,850,000	
Seed	4,000,000	
Shipped east by rail	3,885,000	
Shipped to California	6,500,000	
Exported as wheat	1,565,000	
	32,800,000	
Flour in terms of bushels of wheat:		
Local consumption	12,500,000	
Exported	11,250,000	
Shipped to California	6,500,000	
Shipped to Atlantic and Gulf	2,150,000	
Shipped to Midwest and East	2,550,000	
Cracked wheat and specialty flour	1,150,000	
	36,100,000	
		68,900,000
Total wheat on hand July 1, 1942		53,181,000

SEATTLE TRAFFIC ASSOCIATION,
Seattle, Wash., August 3, 1942.

MR. FREDERICK G. HAMLEY,
Director, Department of Public Service of Washington,
Olympia, Wash.

Re proposed levy of the 5-percent ad valorem tax on freight and express charges.

DEAR MR. HAMLEY: Confirming our conversation relative to hearings before the Senate Finance Committee in the matter of proposed levy of ad valorem tax of 5 percent on freight and express charges, this is your authority to appear on behalf of and representing the Seattle Traffic Association and its membership in opposing the tax which has been included in the revenue bill and passed by the House.

The Seattle Traffic Association is a nonprofit voluntary organization formed in this city on August 15, 1941, to take over the duties formerly performed by the transportation department of the Seattle Chamber of Commerce and the traffic-promotion department of the port of Seattle. In addition, it has a membership of over 100 shippers in this area, representing practically all lines of business, including basic commodities such as lumber, fruit, paper and paper products, livestock, wool, et cetera, manufacturers in numerous other lines, as well as jobbing and retailing interests. For brevity, it is understood that the word "shippers" will include forwarders and receivers of freight and express.

The shippers in Washington, particularly with respect to the basic commodities, will be most adversely affected by a percentage tax on their freight and express charges in that the freight charges paid in order to reach the consuming competitive markets of the central and eastern sections of the United States as compared to the lower freight and express charges paid by shippers from nearby points in the middle west and southern parts of the United States to the same consuming markets, would further broaden the discrimination now imposed by

the recent percentage increases on freight rates recently granted by the Interstate Commerce Commission in *Ex parte 148*.

You are aware that the percentage increases in freight rates as allowed by the Commission has resulted in a dislocation of the freight rate structure and the imposition of a percentage tax on the freight or express charges would further aggravate this situation. It would most certainly emphasize a rate situation which is in our opinion, at the present, unduly prejudical to our producers and shippers. Due to the lack of time, it has not been possible to compile a complete exhibit as to the effect of a percentage tax, but I would cite the following as indicative of the resulting effect upon the long haul shippers:

Eastbound carload commodity rates from North Pacific Coast, Trans-Continental Freight Bureau, Tariff 2-L, I. C. C. No. 1480

Canned goods (item 1610) to New York—$1.49 per 100 pounds:
Carload minimum weight, 40,000 pounds.
Minimum car charge, $593.
5 percent tax, $29.65.
Eggs (item 2065) to New York—$1.96 per 100 pounds:
Carload minimum weight, 33,000 pounds.
Minimum car charge, $646.80.
5 percent tax, $32.34.
Paper (item 3470) to New York—$1.52 per 100 pounds:
Carload minimum weight, 40,000 pounds.
Minimum car charge, $608.
5 percent tax, $30.40.
Dried vegetables (item 4275) to New York—$1.39 per 100 pounds:
Carload minimum weight, 40,000 pounds.
Minimum car charge, $556.
5 percent tax, $27.80.
Wood pulp (item 4430) to New York—$0.64 per 100 pounds:
Carload minimum weight, 80,000 pounds.
Minimum car charge, $512.
5 percent, $25.60.

You can appreciate that the lower rates in effect from the Middle West or from eastern local producing points to the same destination would most certainly result in additional rate dislocations that we have previously referred to and place an undue burden upon the long-haul shipper who is now making heavy absorptions in order to retain his markets.

Another factor that must be given most serious consideration is the President's anti-inflation program whereby every effort is being made to maintain a general price ceiling, particularly at the retail level where it directly affects the consumer in the matter of increasing cost of living.

Furthermore, we feel that the proposed tax will discriminate against manufacture of commodities made from materials wherein the price includes to a large degree the element of transportation cost and that the increases under the present ceiling program could not be equitably distributed. While we are unqualifiedly opposed to a tax on transportation charges, if it is necessary in order to assist in the obtaining of additional revenues for the present emergency, such tax in order to not disturb further competitive relationship should, out of all fairness to the producer and consumer, be based upon a maximum or flat cents per 100 pounds basis rather than the percentage basis and thus eliminate maladjustments which would result under the current proposal.

Yours very truly,

RALPH L. SHEPHERD,
Secretary-Manager.

TACOMA CHAMBER OF COMMERCE,
Tacoma, Wash., August 3, 1942.

Mr. FREDERICK G. HAMLEY,
Director, Department of Public Service of Washington,
Morrison Hotel, Chicago, Ill.

Proposed 5-percent tax on freight charges.

DEAR MR. HAMLEY: Since you are about to appear before the Finance Committee of the United States Senate in regard to the proposed 5-percent tax on freight

charges in the Revenue Act of 1942, Tacoma Chamber of Commerce would appreciate it if you will represent this organization at this hearing. We will be unable to have our own representative present.

Any percentage tax will inevitably most seriously affect our manufacturers since practically all of their products must seek markets in far-distant territory and be subject to very high freight rates. Since our competitors invariably have much lower freight rates applicable to their products, it follows that a percentage tax would subject our manufacturers to a much greater amount of taxation than would be the case with their competitors.

Aside from lumber and lumber products, which are an important item in Tacoma, I would like to call your attention to one of our newer industries, the Ohio Ferro-Alloys Corporation. This industry produces ferro chrome, all of which is shipped to points in the eastern part of the United States. Its rates are considerably over $1 per 100 pounds. Their cars are all loaded to capacity, generally over 112,000 pounds, which would mean a transportation tax at 5 percent of between $55 and $60. Ferro chrome is also manufactured in Ohio and New York State where the rates are comparatively low to the same markets and the transportation tax would be not over one-half of that to which our manufacturers would be subjected and probably less than one-half. Consequently, a substantial handicap would be placed upon our manufacturers.

Any transportation tax would be, in its effect, the same as asking our industries to pay income tax at a higher rate than industries in the eastern part of the United States would be required to pay.

It is our thought that if a tax on transportation must be levied, it should be borne equally by everyone who pays transportation charges. This could best be effected by levying the tax on the basis of a flat rate in cents per 100 pounds. Possibly some commodities could bear a higher tax but the same tax should apply on that commodity regardless of the freight rate applicable on it.

I trust that you will be able to represent us at the hearing and would appreciate having a report from you after the hearing is concluded.

Cordially yours,

JAY W. MCCUNE, *Traffic Manager.*

[Telegram]

YAKIMA, WASH., *August 6, 1942.*

FREDERICK G. HAMLEY,
Washington, D. C.:

Just advised you appearing behalf of this State and others protesting 5-percent tax on transportation. Would appreciate your filing appearance also for Northwest Perishable Traffic Bureau, representing 42,000 carload fruit industry of States of Washington and Oregon, of which I am general chairman. Shippers of apples just been granted special rates by carriers because of economic conditions in industry partially caused by excessive cost of transportation for many years past and proposed tax would wipe out progress made by years of negotiation. Our products necessarily move long distances and percentage increases add heavily to burden and widen margin in costs between our producers, on one hand, and those closer to market, on the other. Winter pears, of which production two States amounts to about 5,000 cars, were formerly largely sold export now must depend for duration on domestic markets which not accustomed to absorb such large amounts and any increase in costs will add to difficulties. Other fruits move largely to Central States with average haul of about 1,700 miles would be heavily burdened by proposed tax. Anything you can do to prevent this additional burden to already harassed industry will be appreciated.

NORTHWEST PERISHABLE TRAFFIC BUREAU,
IVAN L. PLETTE, *General Chairman.*

[Telegram]

PORTLAND, OREG., *August 4, 1942.*

FREDERICK G. HAMLEY,
Director, Washington State Department of Public Service,
Washington, D. C.:

Reference letter August 3 from Washington State Farm Bureau and Washington-Idaho Wheat League the undersigned representing over 7,000 farmer members and operating 350 elevators and warehouses in Pacific Northwest desire to

strongly endorse statement opposing tax on freight percentage basis which would practically destroy our market values and preclude shipments of about one-third our normal crop movement from this area. Would greatly appreciate it if you will submit our position to Senate committee on tax and revenue bill.

NORTHWEST PACIFIC GRAIN GROWERS, INC.,
A. E. SUTTON, *General Manager.*

[Telegram]

SALEM, OREG., *August 4, 1942.*

HON. FREDERICK G. HAMLEY,
Director, Washington Department of Public Service,
Washington, D. C.:

We are sending this wire and this is your authority to represent the State of Oregon in protesting the 5-percent tax on transportation in the revenue bill now before the Senate Finance Committee in the Congress or any other tax based on percentages which penalizes the long-haul grower and shipper from the Pacific coast.

ORMOND R. BEAN,
Oregon Public Utilities Commissioner.

CONSOLIDATED DAIRY PRODUCTS CO.,
Seattle, Wash., August 3, 1942.

MR. F. G. HAMLEY,
Director, Washington Department of Public Service,
Chicago, Ill.

DEAR MR. HAMLEY: Consolidated Dairy Products Co. is greatly interested in the present proposal before the Senate Finance Committee, H. R. 7378, which propounds 5 percent increase in transportation costs to apply on all freight and express charges. The adverse effect on the dairy producers in the State of Washington as well as elsewhere is very apparent. On behalf of approximately 10,000 dairymen in the State of Washington, members of this association, we ask that you use your influence in precluding the proposal from passage as written.

The reason for this request is that since this area produces an excess of dairy products over and above the needs for the immediate territory that they must ship to other consuming centers. Since other areas in the Western States are also producers of dairy products, we find ourselves shipping a great amount of freight transcontinentally. The 5-percent increase in freight will affect us adversely, inasmuch as the rate of freight on goods is the transcontinental rate and is higher than it would otherwise be if we distributed locally only.

In our situation with respect to milk powder specifically, we ship from various plants to the eastern coast on rates which will average $1 per hundred. The increase as proposed would add 5 cents to this, and obviously it would be necessary for us to increase our selling price of this milk powder by 5 cents a hundred or absorb the difference which would represent a loss of that amount to the producers.

An intermediate shipper, for example, in the Midwest can ship for approximately half the transportation cost that we can. Figuring their rate at 50 cents per hundred, their increase on the basis of the proposed 5 percent would be 2½ cents per hundred. Therefore, it would be necessary for him to increase his selling price only 2½ cents per hundred, and obviously he could undersell our producers. The advantage to an intermediate producer would be apparent in that if both midwestern and western producers were to absorb this cost the loss to us would be the greater.

It is not our contention that transportation should not bear its fair share of revenue for the purpose intended. Failing the elimination of the 5-percent increase, it would be our thought that a better plan would be a flat raise of each rate by a fixed amount of possibly 1 cent.

Yours very truly,

CONSOLIDATED DAIRY PRODUCTS CO.,
C. V. DONALDSON.

Mr. HAMLEY. My name is Frederick G. Hamley.

I am director of the Washington State Department of Public Service.

I wish to testify in opposition to the proposed 5-percent tax on the transportation of property, as provided for in section 621 of the revenue bill of 1942, H. R. 7378.

The Washington State Department of Public Service is an administrative branch of State government engaged in the regulation of the intrastate operations of all public service companies within that State.

I have also been authorized and requested to represent the Public Utilities Commissioner of Oregon and the Public Utilities Commission of Idaho at this hearing and to state that they oppose section 621 in its present form.

In addition, I have been requested to represent and express the same sentiments for a number of associations who are listed and whose papers I am filing this afternoon.

Any tax which is placed upon commodities which are produced or manufactured for sale, whether it be an ad valorem tax, a sales tax, or, as in this case, an excise tax, has to be added to the sale price of that commodity and paid by the ultimate purchaser.

Thus, in the case of a carload of pears, if you place a $5 ad valorem, sales, or excise tax thereon, that $5 enters into and becomes a part of the total cost of that carload of pears.

It thus becomes obvious that if you make one carload of pears pay a $5 Federal tax and another carload pay a $30 Federal tax, you have grossly discriminated against the latter.

Now, that is exactly what the effect of this proposed horizontal or percentage transportation tax will be. Let me give you a specific example to prove this:

The cost of shipping a car of pears from the Pacific coast to New York City is approximately $600. A 5-percent tax on this amounts to $30.

A similar car of pears coming to New York City from a much closer point, say, upper New York State, may involve a freight charge of $100, and a 5-percent tax on this car would be only $5.

Senator TAFT. Isn't it true also that $30, then, will enter into the cost of the produce dealer, and then probably into the cost of the retailer, so that the freight charge will be pyramided?

Mr. HAMLEY. Exactly.

Senator TAFT. And the ultimate consumer will pay something well beyond the 5 percent?

Mr. HAMLEY. Undoubtedly. That always works out, where the tax is not placed on the ultimate consumer.

Thus, of two cars of pears competing in the same market, the car which has had to bear six times the freight charges of the other car and is already at a great competitive disadvantage will also be required to pay six times as much Federal tax.

Here is another example, cited by the Public Utilities Commission of Idaho:

The rate on sheep and hogs, double deck, from central Idaho to Chicago, the packing center of the Nation, is $1.08 per hundred pounds.

The transportation tax on this would be approximately 5 cents.

A farmer shipping livestock in Illinois or eastern Wisconsin and Michigan to Chicago might have a rate of 10 cents per hundred pounds and under this measure would pay a tax of one-half cent per hundred pounds.

One car must, therefore, bear 10 times the tax of the other car.

Oregon lumber marketed in New York City would pay double the tax per thousand feet on lumber produced in Alabama and treble the tax on lumber produced in Maine.

Every product of agriculture, the forest, the range, and the factory will be affected in the same manner, and competitive relationships of long standing throughout the Nation will be distorted and, in many cases, broken down if this proposal becomes law.

There is no sound reason why a commodity which happens to be hauled a long distance should pay a greater share of the war's cost than a commodity which is hauled a short distance.

The size of the freight bill is not a fair measure of ability to pay; in fact, the larger the freight bill the less able is the shipper to pay a tax and still compete.

A fair and practicable alternative is available. If, despite the widespread revision of price ceilings which any transportation tax would entail, it is deemed necessary to enact one, it should be on a flat basis per hundred pounds, per ton, or per carload, rather than on a percentage basis. Then each commodity will pay its fair share, discrimination will be avoided, and marketing and commercial practices will not be disturbed.

That the flat basis of assessing a transportation charge is proper, as distinguished from a percentage basis, is recognized in the bill itself, which excepts coal from the percentage tax and requires of it a flat 5 cents per ton tax.

That same principle, applied to all commodities, would be a practicable and fair way of raising the revenue sought to be obtained by section 621.

The proposed tax would be detrimental to the whole Nation.

I am testifying as the head of a State regulatory body, interested in the maintenance of a stable transportation system and in the maintenance of conditions which will make for free and uninterrupted commerce between the States.

A free and uninterrupted commerce cannot be maintained without reasonable and nondiscriminatory rates, and it is even more important that rates be not discriminatory than it is that they be reasonable.

It was for the purpose of overcoming rate discriminations as between shippers that the Interstate Commerce Act was passed and the Interstate Commerce Commission came into being. But it is just as important that there be no discrimination as between regions and localities as that there be none between individual shippers.

In fact, discrimination between regions and localities is discrimination between shippers, only on a bigger scale.

If this section is enacted in its present form the tendency will be to discourage long-haul commerce, denying to the producer and manufacturer his primary markets, and denying to the consumer the advantages of competition and the benefits of a wide field of selection.

And, might I interject, to the extent that this bill discourages long-haul competition, no transportation tax will accrue to the Federal Treasury.

The further tendency of this measure will be for each of the several widely scattered regions of the country to become self-sufficient, producing, manufacturing, and consuming its own goods.

This is not a healthy tendency, for the strength of our country lies in the integration of its commerce and culture.

In opposing this tax I speak not for the West alone. While the discriminatory effect of this tax would be felt most severely in the West, where producers are a long way from their primary markets, the same discrimination will injuriously affect every producer and manufacturer in the country who must compete with others located closer to his market.

And let me also say that the West consumes goods as well as produces them.

We buy huge quantities of commodities manufactured in the East: cereals, soaps, clothing, hardware, machinery, and a host of other things.

The manufactured products of the East may find it difficult to compete with factories which can spring in the West, if they are required to pay Federal taxes of from 5 to 10 times that paid by our local factories. Discrimination works both ways.

In summarizing, we believe that the proposed transportation tax is discriminatory, that it will break down long-standing competitive relationships, that the result will be detrimental to the Nation, and that a practicable and fair method of taxing transportation is available.

I appreciate the opportunity to present these views on behalf of the Public Service Department of the State of Washington and the other governmental agencies and associations which have asked me to represent them here.

The CHAIRMAN. Thank you very much.

Mr. Puckett?

STATEMENT OF B. EARL PUCKETT, WASHINGTON, D. C., CHAIRMAN OF THE TAX POLICY COMMITTEE, AMERICAN RETAIL FEDERATION

The CHAIRMAN. Is your statement lengthy?

Mr. PUCKETT. About 12 minutes.

The CHAIRMAN. Would it be convenient for you to appear tomorrow?

Mr. PUCKETT. It would be most inconvenient for me to do so.

The CHAIRMAN. You may proceed, and make your statement as brief as you can, because we have a group of witnesses here that we wish very much to hear on the nuisance taxes, some of whom must return, if possible, to their States tonight.

Mr. PUCKETT. Thank you very much.

The calendar states that I was to make a general presentation. That was an error. My presentation has to do with the subject of inventory valuations.

My name is B. Earl Puckett. I am president of Allied Stores Corporation, a group of 61 department and dry-goods stores.

I am chairman of the tax policy committee of the American Retail Federation, which consists of 13 large national associations comprising most of the various branches of the retail business, as well as 28 State

retail associations generally representative of all kinds of retailing in the States.

The membership of these 41 associations is more than 400,000 retail merchants—large and small, chain and independent alike.

Over the past several months I have also been acting as chairman of a specially constituted tax committee, the membership of which includes most of the members of the tax policy committee of the American Retail Federation and also representatives of other retail associations which are vitally interested in the subject I wish to discuss with you. Inasmuch as these various retail organizations are in agreement in regard to this question it was felt that, to avoid burdening you with individual presentations of each organization, each of which would of necessity be repetitious as to character, it would be well to make one presentation on behalf of all the groups.

I am appearing before you as chairman of the tax policy committee of the American Retail Federation and also as chairman of the specially constituted committee on behalf of the Institute of Distribution, Limited Price Variety Stores Association, National Retail Dry Goods Association, and National Retail Furniture Association.

I wish to discuss principles and methods of valuing inventories. This is a very important problem as a variation in inventory values directly affects stated profits by the exact amount of the variation—an increase in the valuation of a closing inventory increases stated profits for the period while a decrease in the valuation of a closing inventory has the effect of decreasing stated profits.

In periods of fairly stable price levels and inventory investments reasonably accurate profit statements are obtained from year to year by the use of any of the accepted principles of inventory valuation.

Consistency of principle from year to year gives a reasonably accurate profit picture so long as there is no substantial variation either in the amount of the inventory investment or in the price level.

The problem we wish to discuss has to do with the question of obtaining a more accurate statement of profits in a period of changing price levels.

The past year has been such a period. There is evidence that unstable price levels will be with us for the next few years.

The importance of this problem of inventory valuation takes on added significance at this time also due to the very high tax rates prevailing and to be anticipated.

From a tax viewpoint it is much more important that stated profits accurately reflect true profits when the tax rate approaches 100 percent than when the tax rate ranged from 10 to 20 percent as it did for a number of years.

The effect of including some element of paper profits or paper losses in profit or loss statements was not too great when the tax rates were moderate or low.

The effect of taxing paper profits at prevailing and anticipated rates may be disastrous for many taxpayers.

In common with most industries, retailing has followed the broad principles of valuing inventories either at "cost" or "the lower of cost or market."

The specific problem we wish to discuss has to do with the application of this "cost" principle.

The question is: "In a period of changing price levels are we to assume that sales in a given period are from the most recent purchases or from earlier purchases?"

If we assume that sales are from the most recent purchases the remaining inventory at the close of the year retains the lower "cost" value of an earlier date.

As a result, in a period of rising price levels inventory investments will be more nearly constant, inventory valuations will be on a more conservative basis and stated profits will more closely agree with actual true cash increment from operations.

If, on the other hand, we assume that sales of a period are from the earliest purchases and that remaining stock represents most recent purchases, the "cost" of the closing inventory would be the cost of the most recent purchases, on an item basis.

In a period of rising price levels this "cost" would be higher than under our first assumption.

This higher inventory valuation would, of course, also result in a larger stated profit.

Senator VANDENBERG. Who decides? Is there any rule on the subject?

Mr. PUCKETT. That is what I want you people to decide. There is no hard and fast rule.

Congress has spoken. I will get into that in just a minute.

Let us take an example that is perhaps oversimplified for purposes of illustration.

Assume an article cost the retailer $1, that he sold it for $1.35, and that it cost him $1,20 to replace the article in his stock.

Disregarding operating expenses, how much profit did the retailer make?

Should we consider only the difference between the original cost of $1 and the selling price of $1.35, or should we consider the difference between the selling price of $1.35 and the replacement cost—the later purchase—of $1.20?

We believe the 15-cent differential between the selling price and the cost of replacement—or the later purchase—is a more accurate measure of the retailer's ability to pay taxes than is the 35-cent differential between the original cost—the earlier one—and the selling price.

If the retailer is to stay in business the item sold must in most instances be replaced with an identical or similar item.

The retailer has a minimum inventory requirement in units of goods that must remain constant regardless of price fluctuations.

From the retailer's viewpoint and viewed on a "going business" basis a transaction is not really closed and completed until the item has been replaced in stock.

Only then can the retailer balance his cash and after paying operating expenses have something left out of which to pay taxes or dividends or out of which he can pay his debts or expand.

It is believed that it is quite apparent from the foregoing example that by using the "last in, first out" principle of establishing cost for inventory valuation purposes we get a more accurate picture of results of operations.

The "first in, first out" principle reflects an accounting profit that is not backed up by a corresponding increase in real assets and may therefore be termed a "paper profit."

Of course, in a period of declining prices the situation works just the reverse.

In such a period inventory valuations, stated profits, and taxes will be larger using the "last in, first out" principle than if the "first in, first out" principle is used.

Again, however, we believe that the profit statement more accurately reflects true operating results.

The net effect over a long period of time covering a complete cycle of price fluctuations is to level off the peaks and fill in the valleys of the profit curve.

Over a period of a complete cycle the total profit of the entire period is the same.

From the standpoints of formulating sound business policies and the effects of same on our general economic and social structure there are many advantages in this leveling-off process.

This problem is not a new one. Its significance has long been recognized by business, by the accounting profession, and by Congress.

Use of the "last-in, first-out" principle of inventory valuation has been permitted a restricted number of industries for many years.

In 1939 legislation was enacted granting "any company" the use of this "last-in, first-out," or elective method. Regulations were issued regarding procedures to be followed in its applications.

It is most difficult, if not impossible, to apply these regulations to retailing due to the great number of individual items carried by the retailer and also due to changes in design and construction of these items. Herein lies the retailer's problem.

Many conferences have been held at which representatives of the various divisions of the Treasury, of the public accounting profession and of retailing have discussed this problem.

Up to this time no practical solution of applying the 1939 permissive legislation to the problems of the retail industry has been suggested or accepted by all divisions of the Treasury, although each division has shown a deep appreciation of the problem and evidenced a most cooperative attitude in attempting to work out a proper solution.

The retail industry believes that in principle "last-in, first-out" or the so-called elective method is particularly well adapted to its needs.

A great number of important retail companies have adopted the method for their own accounting and reporting purposes.

In applying the method to an inventory consisting of a great number of items of varying character the adjustment for variations in the price level have been made by the use of price indices compiled by independent agencies.

Regulations, however, have not approved this use of price indices in the application of the "last-in, first-out" or elective method to retailing for tax purposes.

Recognizing the problem facing retailers in this era of increased price levels and of very high tax rates, Mr. Randolph E. Paul, Tax Adviser to the Secretary of the Treasury, after discussing this prob-

lem with representative retailers, appeared before the Ways and Means Committee of the House of Representatives on June 15, 1942, and submitted a proposal for temporary inventory reserves—that was known as exhibit 180 of the unrevised committee print of Treasury data submitted to that committee.

Such reserves are based generally on about the same principle as the "last-in, first-out" inventory method except that the proposed granting of the privilege was only for a stated period, said period made retroactive to January 1, 1941, and to end at the close of 5 years following the end of the present war emergency.

Making the provision retroactive to include 1941 is believed advisable, due to the substantial increase of from 15 to 20 percent in the price levels of general merchandise in that period.

Mr. Paul's suggestions contemplate setting up reserves in periods of increasing price levels and absorbing these reserves into profits in periods when the price level is declining, and also the use of Treasury approved indexes in establishing the maximum amount of reserves so established without requiring specific identification of individual items of merchandise.

His suggestions also provide that any unused reserve at the end of the period shall be taxable at that time, with permission to spread payment of the additional tax over a 3-year period if desired.

Senator VANDENBERG. Are those recommendations of Mr. Paul's in the House act?

Mr. PUCKETT. They are not in the House act. As I understand it, they were made while the committee was in executive session.

There was a newspaper report that there was not time to include them in the drafting of the bill, but I can't vouch for the accuracy of that.

Senator VANDENBERG. They are not in the bill?

Mr. PUCKETT. They are not in the bill. The retail organizations which I represent believe:

1. That we are entitled to the same degree of care and protection against fictitious profit showings in periods of fluctuating price levels that has been shown other industries. This is a problem common to all retailers—large and small, chain and independent, the general store and the specialty store alike.

2. That the "last-in, first-out" principle of inventory valuation, the use of which was granted to "any company" by Congress in 1939, more accurately reflects true profits of our industry than does the "first-in, first-out" principle.

3. That principles involved have to do with changes in price levels and their effects on the valuation of required inventories rather than with the specific identification of individual items of merchandise.

I might say that this point No. 3 is where we have some of our controversy with certain divisions of the Treasury. They have argued that it is extremely difficult to apply the principle unless you have specific identification of items.

4. That a proper application of the "last in, first out" principle results from the use of price indices where an inventory consists of numerous items varying somewhat from year to year in design and specification.

5. That the suggestions made by Mr. Paul in his presentation to the Ways and Means Committee of the House of Representatives on June 15, 1942, regarding temporary inventory reserves, in effect, accomplish the same ends so far as meeting the needs of the present and near future are concerned. From the viewpoint of the Treasury his proposal has the advantage that it affords complete assurance that no true profits will permanently escape taxation.

I have attached a copy of Mr. Paul's recommendations.

Senator VANDENBERG. Are they agreeable to you?

Mr. PUCKETT. They are entirely agreeable to us. They do not follow the exact form to which we think we are entitled, but the effect is perfectly agreeable to us.

Senator TAFT. Would it be a real reserve?

Mr. PUCKETT. It would be a real reserve.

Senator TAFT. Would you have to invest the money?

Mr. PUCKETT. No. It would be a valuation reserve set up as prices increase, and as prices decrease, the reserve would be absorbed back into the taxable profits.

On the complete cycle of profits, the total profit is exactly the same.

The proposal has one thing that we don't like, but we are willing to accept that—that is if we have not absorbed the profits when the war is over and if prices decline, we have to pay a tax on that reserve.

In conclusion: Times are uncertain. Many new problems face all businesses. The retailer occupies an important place in our domestic economy. Many problems growing out of the present war emergency bear particularly heavy on the retailer.

Tax rates are necessarily quite high. We only ask that we not be required to apply these high rates to fictitious or "paper" profits, but that taxable profits be as accurately determined as possible. For these reasons and on behalf of the retail organizations I represent I wish to endorse proposals made by Mr. Paul to the Ways and Means Committee of the House of Representatives on June 15, 1942, and to urge upon you the acceptance of those proposals.

(The document produced by Mr. Puckett is as follows:)

STATEMENT BY RANDOLPH E. PAUL, TAX ADVISER TO THE SECRETARY OF THE TREASURY, BEFORE THE WAYS AND MEANS COMMITTEE OF THE HOUSE OF REPRESENTATIVES, ON INVENTORY RESERVES

The enactment of high corporate tax rates necessitated by the war makes the correct determination of the income to which these rates are applied of fundamental importance. Under the present treatment of inventories for tax purposes, in periods of rising prices taxable income may include profits that result merely from the increase in the value of the inventory on hand. Such profits are not available for the payment of taxes and may be wiped out by subsequent price declines.

The first-in first-out method of accounting for inventories required under present law for most taxpayers can result in the inclusion of inventory profits in taxable income. As long as prices do not change, this method gives satisfactory results. If a taxpayer has on hand the same amount of goods at the end as at the beginning of the year and prices paid for his goods do not change, it makes no difference whether in computing his income he takes as the cost of the stock he sells the cost of the units he had on hand at the beginning of the year or the cost of the units he purchased during the year. However, if he pays a higher price for goods purchased during the year than he paid for goods on hand at the beginning of the year, the method of inventory valuation becomes important. If he considers that the particular item sold came from the inventory on hand at the beginning of the year, he will compute his profit by deducting from the price at

which he sold the ... tory. If prices are rising ... if income is computed by deducting ... purchased during the year. If ... higher apparent profit ... dends, since a larger sum ... was deducted in computing profits.

Congress has already recognized ... taxpayers permission to use the ... ventories. This method in general ... able income. However, many taxpayers ... method, particularly taxpayers whose ... different products rather than a few homogeneous ...

The Treasury believes that during the ... payers, and not only those who are ... be safeguarded against the inclusion of ... The problem of fluctuating inventory ... for the price ceilings recently imposed. ... tive in keeping prices at their present level ... be absent. However, even with effective ... remain.

A substantial price rise took place before ... January 1941 to March 1942, wholesale prices ... and many individual prices showed substantially larger increases. Some of the resulting inventory profits were reflected in the ... appear in the tax returns for 1942. In addition, ... from the price ceilings and readjustments ... commodities. Moreover, substantial price ... war when the ceilings may be relaxed. ... Congress can give taxpayers the assurance that ... pose the heavier taxes occasioned by the war ... Taxpayers will then be able to adjust their inventory ... war program without regard to tax considerations.

The Treasury therefore proposes that taxpayers be permitted to establish temporary reserves for possible future inventory losses. These reserves to be deductible in computing taxable income. The maximum amount to be added to the reserve in a year of rising prices, and hence to be deductible in computing income for that year, will be equal to the approximate amount by which price inflation has increased the value of the basic inventory during the year. Similarly, in a year of declining prices, the taxpayer would be required to subtract from his reserve, and hence to include in his income, the approximate amount by which price deflation has reduced the value of his basic inventory during the year. (An example of the operation of the reserve is attached.)

PERIOD TO BE COVERED

Under the plan proposed taxpayers would be permitted to set up reserves for the period beginning January 1, 1941, and ending 5 years after the close of the war. It is proposed that the reserve be applied retroactively to 1941 because of the substantial price increases which occurred in that year. Similarly, the reserve should remain in effect long enough after the war to include post war adjustments. Taxpayers would not necessarily be required to begin with 1941, they could start at any time.

TAXPAYERS ELIGIBLE TO USE RESERVES

The use of reserves would be permitted to all taxpayers with inventories of real goods, as distinguished from the portfolios of financial institutions. Taxpayers would be permitted to use the reserves for inventories not valued under the elective last-in, first-out method.

INVENTORIES TO BE COVERED BY THE RESERVE

The taxpayer would not be required to use the reserve method for his whole inventory. He would be allowed to elect the reserve method for selected parts of his inventory, provided that they are clearly identifiable. The election, once made, could be revised only with the approval of the Commissioner of Internal Revenue.

ADDITIONS TO AND SUBTRACTIONS FROM THE RESERVE

When prices rise, taxpayers would be permitted to add to the reserve the approximate inventory profits. If, however, a taxpayer did not desire to credit the reserve with the full amount allowable, he would be permitted to credit the reserve with a smaller amount, or he could refrain from taking any portion of the credit to which he was entitled. The taxpayer electing not to take the maximum allowable credit in any year would not be permitted to take the unused credit in a future year.

In years when prices decline, taxpayers would be required to charge the reserve with the full amount of the approximate inventory loss. Such charges to the reserve could not exceed the credit balance in the inventory reserve.

COMPUTATION OF APPROXIMATE AMOUNT OF PROFIT OR LOSS

The approximate amount of profit or loss would be determined by multiplying the basic inventory by the estimated change in prices during the year. The basic inventory will be taken as equal to the smaller of the physical inventories on hand at the beginning and the end of the year. In other words, it is limited to the inventory common to these two periods. The administrative complexities involved in extending the treatment beyond this point outweigh its possible benefits.

The estimated change in prices will be determined by the use of specified price indexes. The coverage of the price indexes would conform as closely as possible to the actual inventory of the taxpayer and their selection and application would be subject to the approval of the Commissioner of Internal Revenue.

Taxpayers would have the option of computing inventory profits and losses for the entire inventory as a unit or for narrower classes of inventory goods. The election made by the taxpayer would be subject to change only upon approval by the Commissioner.

LIQUIDATION OF PART OF THE INVENTORY

If any part of the inventory is liquidated, the reserve against this part of the inventory would be creditd to income.

TERMINATION OF RESERVES

The reserves may be terminated either by the exhaustion of the accumulated reserves or by the legal expiration of the reserve provision, that is, 5 years after the close of the war.

If the reserve is exhausted by price declines or inventory liquidations, no further use of the reserve method would be permitted.

If the reserve is terminated by legal expiration, any amounts remaining in the reserve would be returned to income, since the purpose of the reserve is solely to safeguard the taxpayer from the inclusion in his taxable income of profits arising from temporary price rises. In order to prevent a severe drain on cash resources in the event of a possible heavy tax on large unused reserves, taxpayers could be permitted to distribute the payment of the tax liability attributable to the unused reserves over the 3 years subsequent to the termination of the reserve.

The proposed inventory reserve will prevent in substantial measure the taxation of inventory profits destined to be wiped out in the next few years. At the same time it will not permit profits from a permanent rise in values to escape taxation.

EXAMPLE OF THE OPERATION OF THE INVENTORY RESERVE

A. EFFECT OF INVENTORY AS PRICES RISE

1. *Under first-in first-out method.*—Suppose that at the beginning of the year the taxpayer has on hand 1,000 units of a product, which he has purchased at $10 apiece and which he expects to sell at $12 apiece. The taxpayer expects to earn a profit of $2 on each unit sold, or a total profit of $2,000. Actually, however, by the time he sells his product the price has risen to $16. Thus, apparently, the taxpayer has earned a profit of $6 per unit or $6,000 in all. But if the taxpayer is to remain in business, he must maintain a stock of inventory goods on

hand. Now, when he purchases new inventory goods to take the place of those sold, he finds that the cost price of his product has also risen by $4, from $10 to $14. Thus, in order to maintain a constant physical inventory of 1,000 units, he must reinvest $14,000 of his $16,000 receipts in the replenishment of the inventory. Consequently, he has only $2,000 free cash as a result of his transaction. The other $4,000 is tied up in inflated inventories.

Under the first-in first-out method of valuing inventories, his income would be $6,000 in spite of the fact that $4,000 of this profit simply represents a higher book value on a constant physical inventory.

2. *Under the reserve method.*—Under the proposed reserve method, however, the taxpayer would be allowed to deduct from the $6,000 an amount corresponding to the increase in the book value of his physical inventory, in this case $4,000. Thus, if the taxpayer maintained his business at a constant rate of operations, his taxable income under the reserve method would equal $2,000 and would coincide with the amount of free cash available for the payment of taxes and dividends.

B. EFFECT OF INVENTORY AS PRICES FALL

1. *Under the first-in, first-out method.*—Assume that the price movement is reversed and prices fall to their original levels. The taxpayer has on hand 1,000 units of inventory goods purchased at $14 each, which he expects to sell at $16. Actually, by the time he sells them the price has fallen to $12. Thus, apparently, the taxpayer has lost $2 on each unit or $2,000 in all. When the taxpayer purchases new inventory goods, however, he finds that they cost only $10 each. In other words, although the taxpayer has apparently lost on the transaction, he is able to maintain his physical inventory and still have $2,000 free cash.

Under the first-in, first-out method of valuing inventories, the taxpayer would show a loss of $2,000 in spite of the fact that he would have a profit of that size if he disregarded the change in the value at which he carries his inventories on his books.

2. *Under the reserve method.*—Under the reserve method, however, the taxpayer is required to subtract from his reserve the $4,000 representing the decrease in the book value of his constant physical inventory and add this amount to his taxable income. Thus, if he maintained his business at a constant rate of operation, his taxable income under the reserve method would equal $2,000 and, once again, would coincide with the amount of free cash available for the payment of taxes and dividends.

JUNE 15, 1942.

The CHAIRMAN. The witnesses who are scheduled to appear today on vending machines, three in number, parts and accessories, three in number, have very kindly consented to appear tomorrow.

Now we have reached the pari-mutuel taxes, and it is obvious that we will have no additional time for today. Therefore, those who are appearing on this question of pari-mutuel taxes may rearrange your witnesses in any order that you wish them called, if by so doing you might accommodate someone who has to leave the city tonight.

Although the committee hopes that you may be able to finish with all the witnesses this afternoon, we made that suggestion now so that if you——

Mr. BROUN. Do I understand that we may be heard at this time?

The CHAIRMAN. At this time; yes, sir.

Mr. BROUN. I think we can conclude in a very few moments. We have no witnesses. We expect to have two, or perhaps three, gentlemen, who will address you very briefly.

The CHAIRMAN. Yes, sir.

Mr. BROUN. I happen to appear here—perhaps my reason or excuse for being here is that I am president of the National Association of State Racing Commissioners.

The CHAIRMAN. Is this Mr. Broun?

Mr. BROUN. Yes, sir.

The CHAIRMAN. Mr. Underwood is listed first.

Mr. BROUN. He is secretary of the National Association of State Racing Commissioners.

The CHAIRMAN. Mr. Broun, do you wish to appear first, or Mr. Underwood?

Mr. BROUN. It was suggested that I introduce these gentlemen, or indicate who will speak first.

The CHAIRMAN. That is right. We are ready for the first speaker.

Mr. BROUN. Yes, sir. Then, the first speaker is the Honorable Herbert Swope, chairman of the State Racing Commission of the State of New York.

The CHAIRMAN. Come around, Mr. Swope. We will be glad to hear from you.

STATEMENT OF HERBERT BAYARD SWOPE, NEW YORK, N. Y., CHAIRMAN, NEW YORK RACING COMMISSION

The CHAIRMAN. Mr. Swope, you may be seated or you may stand, just as you wish.

Mr. SWOPE. Well, I will do both.

I want to, on behalf of myself and the State of New York, express my appreciation at this opportunity of being heard, and to say that I have come here with no brief, but I should like to lay before you a few points that we in New York think are compelling in any consideration of a tax of this nature.

Let me, at the outset, gentlemen, say that New York and the other States which are represented in the National Association of State Racing Commissioners are in no sense of the word opposed to a tax that is intended to aid the development of the war program.

However, we are fearful of this particular tax. We are fearful of it for one very well-defined belief: That none of us who have had opportunities to study this rather perplexing problem but believes that the tax will not yield the return that has been estimated—25 millions—for many reasons, but primarily three. Before I go into them may I say that the Treasury has neither recommended nor supports—neither recommends nor supports—this tax.

I give you that for what it is worth.

There is a total of approximately $520,000,000 bet legally in America—that is the statistic in the reports that New York and the other States submit—but the figure is more apparent than real.

That is a cumulative turn-over. None of us has proven sufficient mathematician to discover how much original capital is involved.

We have taken it up with higher authorities, and as nearly as we can develop a formula, a little less than one-third of the total amount represents fresh capital.

In other words, in total pools or handles, we find probably 30 percent or 29 percent of that total figure to be actually fresh money in your pocket. The rest is turned over in the six or seven or eight races that are carded each day.

Second, California is no longer racing, and that means a drop of probably one hundred or one hundred and five million dollars taken off the top, reducing the total by that amount.

Third, we are convinced, by a rule of thumb, that the present tax, which varies from 10 percent to as high as 15 percent, plus the

breakage—I won't bore you with the details of breakage now—is as high as the traffic will bear.

Some of us think—and this I must be frank enough to say to you is not universally accepted, but in the great majority of instances it is—that the median line is approached at 15 percent, and after that is passed the law of diminishing returns asserts itself.

We find this axiom: The more bet the more tax; the more tax the less bet.

Florida—although the distinguished Governor of Florida is here and is capable of speaking for that State far better than I—is a case in point.

They imposed a tax that, after careful consideration, they thought had reached their maximum—their peak. It runs between 15 and 16 percent.

The returns this year were less than last year when the tax was only 10 percent.

Senator CLARK. Do you mean the return in actual tax paid?

Mr. SWOPE. No, sir. I am glad you corrected me. That is very important. I mean the total handled. Because the public will not bet against too bad a situation.

In other words you can't raise the ante without killing the game, if you gentlemen know what I mean.

Senator BARKLEY. That is not a term ordinarily used in horse racing.

Mr. SWOPE. By all sporting gentry, Senator, particularly in Kentucky.

California had an alternative formula under which the State received a total tax, taken out of the handle, out of the pools, of 12 percent.

Four percent of it went to the State; 8 percent of it went to the tracks.

Santa Anita tried an experiment and reduced its take—its kitty—to 6 percent from 8, and instantly the handle went up.

In other words, a man feels, I suppose, if I can speak for the players, a greater opportunity of getting return on his investment if only 6 cents is taken out of his dollar than if 8 or 10 cents is taken out of his dollar.

Now, when his resistance becomes active and he will no longer patronize the races, it is the conjecture, I believe, that that line has been reached at about 15 percent.

There are 22 States where betting has been legalized. Nineteen are functioning.

The collections have been enormously profitable for the States.

It is a clean collection, such as I imagine the Finance Committee wants in each case of taxation. We were taught in New York to believe, under the doctrine laid down by the President of the United States, that this subject lies definitely within the zone of State taxability.

It would be obvious for me to point out an injustice exists in the fact that the 19 States that do function under this pari-mutuel system would be taxed and the moneys derived therefrom would be supporting States that do not give this privilege. Perhaps it would not be amiss for me at this moment to say that we regard this as a special privilege business, but one that pays heavily for that special privilege.

The regions that include racing as one of their major sports have shown a pretty steady increase, in spite of war conditions, and I think it is safe to say that Mr. Randolph Paul, whom I am told is a distinguished tax expert, thinks there is some virtue in the system of taxation, because it siphons off some of the money of the public painlessly, unless they lose too much, and thus prevents that inflationary rise that always follows too great a purchasing power.

I shouldn't like to press that point, because, obviously, by that process, if you put the tax too high you would have nothing at all left.

Senator GERRY. Do you figure that, if the tax is too high, that it will drive betting to the bookmakers?

Mr. SWOPE. If the tax on the track is raised to an exorbitant figure you instantly develop bookmaking. The bookmakers can afford to lay a point or two above the market, because they have no overhead at all. Their business would be increased enormously and, of course, they are quite beyond the reach of any taxation.

That was proven in New York in the old days, and proven again in Florida.

Senator BARKLEY. They are not only beyond the reach of the law but they are also beyond the reach of taxation and, of course, it is difficult to regulate something that isn't——

Mr. SWOPE (interposing). I needn't point out to experienced legislators that that always promotes a criminal alliance between some of the subordinate authorities and the pool men.

Senator CLARK. To the extent to which you legalize such as the pari-mutuel system you put a premium on handbooks?

Mr. SWOPE. If the take is too high.

Senator CLARK. That is, I say, to the extent to which you put a penalty on them?

Mr. SWOPE. Yes, sir.

Senator CLARK. For instance, in our State racing is not legal. In Illinois, right across the river from us, it is legalized.

A great many people go across the river to the race track at Fairmount, right across the river.

Despite that fact it is a well-known fact that there are a lot of handbooks over there.

If you make too heavy a penalty on the legalized betting at the track it throws that business largely into the hands of the illegal handbook operators on our side of the river. People stay at home and bet with them.

Mr. SWOPE. You have put it precisely. I should like to give you if I may, a fairly concrete illustration.

It seems incredible, but it is nevertheless true. A 15 percent tax today, what with the incidentals, comes to about 19 or 20 percent tax, because, of course, you have got your transportation to pay for; you have got your food to pay for; you have got your companion—if you are lucky—to pay for; and other items of outgo. Assume 20 percent would represent the tax upon capital, on a low minimum, of $300,000 a day—a pool of $300,000—then the take is $60,000. Therefore, the group that goes to the track, on a 20-percent basis, with a hundred thousand dollars in their pockets—according to my formula of one-third of the total pool being fresh money—has $60,000 taken out of

it by the operation of the tax in various forms, if he stays even. Not many of us do. Do I make my point plain? Two-thirds has been taken.

Senator BARKLEY. That would be only for 1 day; is that right?

Mr. SWOPE. Yes, sir.

Senator BARKLEY. He went to the track on one day with a hundred thousand dollars in their composite pocket, and it would take $60,000 out of that. If that operated each day, they wouldn't be able to race more than a day and a half until they would have it all; wouldn't they?

Mr. SWOPE. That is exactly the operation of the kitty.

Senator TAFT. What is the State tax in different States? What does the State get?

Mr. SWOPE. Varying sums. I can answer that question with respect to each of the States.

In New York the tax is 10 percent, of which the State gets—after January 1 next year—6 percent and the track 4 percent.

Senator TAFT. That is what I mean. When you say tax, you are using the term in over-all take?

Mr. SWOPE. Yes, sir.

Senator TAFT. But the State tax itself is 6 percent in New York?

Mr. SWOPE. Six percent, and the track gets 4 percent.

In California the total take is 12 percent, with the State getting 4 percent and the tracks getting 8 percent, sometimes only 6 percent.

In Florida the total take is 15 percent, with the State getting 8 percent and the tracks getting 7 percent and no breaks.

In Massachusetts the tax is 10 percent, with the State getting—I think it is 3 or 4—let me look at this—3½ percent.

New York and Florida tax most highly.

New Jersey—a new operation—is 10 percent, with 5 percent of the pari-mutuel going to the State.

Rhode Island is 10 percent, with 3½ percent on the pari-mutuel going to the State.

We have just raised our tax in the State of New York from 5 percent to 6 percent. I am not going to complicate this situation by going into a mathematical dissertation on what they call the breakage, but that is another source of income to the States usually.

Breakage is fractions over a nickel. Some inventive genius discovered that people don't like to be troubled with pennies.

I personally have always fought for pennies in New York, but we break to 5 cents.

All the States in America break to 5 cents, except West Virginia, 10 cents; New Hampshire, 10 cents; Michigan, 10 cents; Massachusetts, 10 cents; California, 10 cents; and Illinois, 10 cents.

The other 14 break to a nickel, and that amounts to about—out of the pockets of the public again—almost 1 percent on a 5-cent break, and on a 10-cent break almost 2 percent.

As a matter of fact, a 5-percent Federal tax would amount to really a hundred-percent increase in the total tax imposed, because, as I say, the average tax is about 5 percent for the States.

The States get a tax total of about $25,000,000.

Senator GERRY. What is the Illinois tax?

Mr. SWOPE. You mean the division—10 cents, with 2 cents going to the State, and 8 cents going to the tracks.

Senator BARKLEY. Is that 10 cents provided in the statute?

Mr. SWOPE. Yes.

Senator BARKLEY. And that division is also fixed in the statute?

Mr. SWOPE. Yes, sir.

Senator BARKLEY. And that goes into overhead expenses?

Mr. SWOPE. The overhead expenses, including the purses; the operation of the crews; the staffing of the track, and the printing of the tickets and such.

The statute in New York reads, for example, that the entire money shall be returned to the public, less 10 percent, which shall be withheld, of which 6 percent goes to the general fund of the State and 4 percent goes to the track.

There are about twenty-five millions collected for the State treasury from these various sources. This is inclusive only of horses; I know nothing about the dogs.

We feel that the State uses a specific creative power to license the tracks. I have never been able to see that the Federal Government has such a right. It grants nothing. The State franchises these tracks under very sharp regulation, and if the Federal Government were to attempt to impose this tax I think it would be necessary to have a long series of regulatory enactments to protect the Government's interests. It would set the Government up in the business of being a partner in a gambling enterprise.

New York and other States happen to be, but I don't know whether the Federal Government is willing to be.

Senator BARKLEY. Let me ask you about your estimate a while ago, that only about a third of actual money is used in betting.

Mr. SWOPE. Yes, sir.

Senator BARKLEY. Although the figure would show three times that much money.

Mr. SWOPE. Yes, sir. That is right.

Senator BARKLEY. Let's see if we can illustrate it by a man going to the tracks, say, with $30 in his pocket, and there are eight races, or six or eight.

He bets on each race and he wins a little and he loses a little, and at the end of the day he has still got $30, but he may have made $90 worth of bets in the turn-over; is that right?

Mr. SWOPE. That is right.

Senator BARKLEY. So that this tax applies to the $90 that he has turned over, which is the same money he borrowed, instead of the $30 which he carried there and which he took away?

Mr. SWOPE. That is right, except that the $30 which he came with, when it is turned over to $90 by being bet and rebet, and re-rebet, has to come out of somebody else's pocket. There is no addition to the first man's capital. It has to be taken from this gentleman or that gentleman.

Senator BARKLEY. But the 5 percent is paid on the $90?

Mr. SWOPE. Yes; on the turn-over.

Senator BARKLEY. On the turn-over?

Mr. SWOPE. It is a turn-over tax.

Senator BARKLEY. Therefore the tax on that amount would be $4.50?
Mr. SWOPE. Right.
Senator BARKLEY. Which really is $4.50 out of $30; is that right?
Mr. SWOPE. Yes, sir.
Senator BARKLEY. Of course, that tax couldn't come out of him if he goes away with $30, and having come there with $30 he probably has had some fun but hasn't made or lost anything, but that $4.50 comes out of somebody, and had to be taxed?
Mr. SWOPE. Yes; but his case isn't universal. He will have to have had contributions, involuntary contributions I may say, from the other fellow, because his $30 must have been increased. You must remember in addition to 5 percent tax he pays the track as much more, and additional outgoes for incidentals. There is no addition to the original capital brought there.
Senator BAILEY. The race-track tax and the State tax in the pari-mutuel consumes—only one-third of it is original money?
Mr. SWOPE. Fresh capital; yes, sir.
Senator BAILEY. Isn't that the same thing with the United States Government? We lay a tax of $22,000,000,000 a year. The money in circulation is $10,000,000,000.
Mr. SWOPE. But, on the other hand, you are laying it on——
Senator BAILEY (interposing). The point is the transactions. Now, the actual circulation in the United States is probably $500,000,000,000 in transactions. We base our taxation not on the new money but on the total transactions, but you seem to complain here that this tax relates to the total transactions, yet precisely all taxes do.
Senator BARKLEY. He brought that out before you arrived in illustrating a point that a 5-percent tax would not produce the amount of revenue that is claimed for it.
Senator BAILEY. I am just showing how that would work. You might figure that you couldn't get $22,000,000,000 out of the people where the circulation is only $10,000,000,000, but we do, of course, have a tremendous turn-over. Each possesses new money.
Mr. SWOPE. Do I understand, then, Senator, that the doctrine of taxation is to produce a second tax on the volume of turn-over?
Senator BAILEY. It is based on the volume of business and not the new money; that is all I am saying.
Mr. SWOPE. There is, unfortunately, no production of wealth in racing. It is a sport, a relaxation. I hope you regard it as such. Whereas in business enterprises at least you are creating the wealth from which the Government exacts a tax.
It seems to me it would be very difficult to make a comparison between racing and business. One is completely outgo and the other is income on which you base your tax.
However, I will yield to your superior knowledge of the taxation problem.
Senator BAILEY. I don't have any superior knowledge. I have been greatly mystified by all this talk about antes and kitties.
Mr. SWOPE. We have a parallel to bootlegging that Senator Gerry directed my attention to, and that is that the bookmakers will invariably flourish when the take is too high.
Some of the tracks, when the take is high, have tried it, but they came down voluntarily.

As I say to you, California made a voluntary reduction, almost unheard of, of 2 percent. There were some experiments in Michigan, which now takes about 7½ percent, all of which goes to the tracks, but they place a daily license fee of something like $2,500 or $3,000 on each day's program.

Racing represents, in its widest ramifications, about $160,000,000 of investments, if I may be permitted to include the farm lands that are utilizable only for the purposes of fodder.

In your State, Senator Barkley, the acreage, I think, is as high as one hundred to one hundred and fifty thousand, which would normally be thrown into agricultural produce, now used entirely for pasture.

Kentucky, of course, the cradle of the thoroughbred—and other things——

Senator BARKLEY (interposing). It is not always a cradle.

Mr. SWOPE. Racing this year has done surprisingly well in the face of three great factors of embarrassment. Racing has made a very honest effort—I should like to leave that thought with you—to completely fit into the war program, by asking no special favors but providing the sport if the public wants it—and they do want it—as a form of relaxation, that has curiously enough been maintained in every warring country.

The gas rationing, of which you may have heard; the rubber scarcity, which is about to be established; and transportation difficulties; have caused racing to become extraordinarily attenuated, but the people want racing, and they have gone in great numbers. They pay stiff prices.

In New York we have a theory of paternalism, which protects a man from himself, and you can't get in for less than $4.50 or $2.25, exclusive of incidentals. It has gone well, because of the fact that it has been, I think, honestly and reasonably run, and because there is a thrill in the sport and a reaction to the thoroughbred that no other sport provides.

There are about 175,000 people who get their living from it, and I am very glad to add this: That none of us in racing is evading the draft. We are either much too old—not to be too autobiographical—or the jockies are much too young or too puny.

So we have done no violence to the draft.

I would like to say, in conclusion, that racing today is raising $2,000,000 for the national relief, and that is like extracting back teeth.

Not that the producers weren't willing to give it, but racing is by no means the Golconda that has been recently pictured. The States have discovered that it is a lucrative source of tax, and they are getting theirs.

We will raise the two millions. We have about $1,400,000 on the line now, and we hope to be able to complete it before the snow flies.

Senator CONNALLY. What percentage of racing is on the pari-mutuel system rather than the old?

Mr. SWOPE. All racing in America is now on the pari-mutuel system, Senator.

Senator CONNALLY. All of it?

Mr. SWOPE. All of it.

Senator CONNALLY. That is, on a recognized basis? You don't mean that there are no scrub races out in the country? You mean recognized racing establishments on the pari-mutuel system?

Mr. SWOPE. There may be some quarter races, as between Squire Connally and Squire Barkley, but no racing other than pari-mutuel is permitted in America; even in amateur hunts.

Senator GUFFEY. What about county fairs and trotters, Mr. Swope?

Mr. SWOPE. I was not referring to trotters. Just the thoroughbreds. I could refer to nothing else in the present circumstances.

But even then, as Mr. Underwood can tell you, I don't believe there is one State in the Union that permits racing without the pari-mutuel, except at county fairs.

The total tax in New York, so far as we have been able to estimate from the bureau of statistics we maintain there, that is paid, inclusive of the income tax, runs to about $50,000,000. I should like to be permitted to repeat that racing is eager to do its share in the war and will assume any tax that it does not believe will be destructive of the sport we are seeking to keep alive.

Any more questions?

Senator BARKLEY. I would like to ask you this, Mr. Swope: If the levy of a tax, either State or National, should become so heavy that there would be a diversion from what is legalized to what is not legalized, would that, in your opinion, bring about, if long continued, a decline in the thoroughbred horse—the quality of a thoroughbred horse—so as to affect that industry in the State where it is carried on?

Mr. SWOPE. I think it would kill it, because the race track is a laboratory of the horse, and his breeding can be tested only by his racing.

Senator BARKLEY. His performance?

Mr. SWOPE. Racing has always had, as its concomitant, betting. The race track itself could not live without betting, and the horse could not live without the track.

Senator BARKLEY. That is all.

The CHAIRMAN. Thank you very much.

Whom do you have next, Mr. Broun?

Mr. BROUN. Mr. Underwood has prepared a brief, and I think you will find it very helpful.

STATEMENT OF THOMAS R. UNDERWOOD, LEXINGTON, KY., SECRETARY, NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

Mr. UNDERWOOD. Gentlemen, I don't know exactly the rules of the committee.

I have a brief here with a good deal of detailed information in it.

If it is permissible to do it, I would like to turn it over to the committee without reading it or trying to get it into the record.

The CHAIRMAN. That is quite all right.

Senator BARKLEY. You mean you would like to have it printed in the record?

Mr. UNDERWOOD. No, sir. I just want to submit it so that any Member who wants to can make use of those figures.

Senator BARKLEY. I suggest that it be distributed among the members.

The CHAIRMAN. Yes. We will be very glad to distribute them.

Mr. UNDERWOOD. I might say—I don't know whether it answers it or not—but the question that was asked Mr. Swope by Senator Bailey about whether the Federal Government take in taxation is coming from a turn-over amount of money: I think that is entirely different, because the Federal Government's money that is taken out does go back again where it can be taken out again, but the amount of money that the Federal Government takes from the pari-mutuel pools will not be put back into the racing pools, so that money will be absolutely taken out of there.

In regard to bookmaking, it has been suggested that a high take-out will drive betting to bookmakers. I don't think there is any doubt about that, but there is another very definite step that would follow a higher tax and a higher take-out, and that would be the reduction of purses and stakes by the tracks.

We see sometimes a million-dollar day at a track—say a million-dollar Derby day.

If 10 percent of that is taken, that makes a $100,000, which looks like a tremendous amount of money. But if you subtract $75,000 as the derby stake, why, you see, it doesn't leave so much, and the essence of good racing is to have races made for the purses—that is where your regulatory problem comes in—and if those purses are cut the better types of horses are going to start disappearing.

In other words, the stables that are supporting them will not be in racing.

Of course, our State is vitally interested in that, and we believe that the horse farms represent the biggest privately financed conservation enterprise in the United States, and it is definitely of value to the country; and thoroughbred lines are crossed to produce many types of work, Army, hunter, and riding horses.

The profits of Keenland in Lexington are used for the study of horse diseases, and the whole breeding industry is so related to agricultural enterprise, livestock and blood-stock breeding, in the country, that there is no way to divide them, and it would be a very, very serious loss to the country if that were destroyed.

I expect you gentlemen have heard the story about Henry Watterson, when he had the custom of taking the money in the cash drawer at the Courier-Journal, and was told repeatedly by the cashier that he would have to leave some note or word as to how much he had taken so that she could keep the books clear.

She kept after him time and time again on it, and finally he agreed he would do it the next time, so the next time he just left a note and said, "Took it all."

I think that these figures will prove that the State governments are now undertaking to take it almost all, and they have in many cases licensed racing for the purpose of getting State revenues. Obviously they are taking all they can.

Senator BARKLEY. Let me ask you this question: Suppose that the result of this tax—or any tax—is more than the traffic would bear, and should result in a decline of the thoroughbred horse upon these valuable farms now devoted to livestock, what would be the effect in bringing about, to some extent, competition in the production of other

agricultural products that those farms would have to produce in order to live?

Mr. UNDERWOOD. It would simply invite, for our country, the fate of the Dust Bowl.

That land that is in grass will grow mighty good tobacco, and nobody is paying the people down there, who are growing that grass now, not to grow tobacco. They are growing grass on it.

They are producing not only horses, but, on the same land, sheep and cattle, and we have as many arguments there between the horsemen who raise sheep and the horsemen who raise cattle as we do between the trotting horsemen and the running horsemen, but it is strictly linked with a tremendous agricultural enterprise, and this country is now, today, the depository of the great horses of the world that have come here—Blenheim II, Sir Galahad III, Mahmoud—you could just name them in a long string.

Not only must they furnish the blood lines for horses all over the world in the future but also such stock farms must produce purebred sires for all types of blood stock.

The production of all types of pure-blooded animals is linked with the breeding industry—thoroughbred breeding industry.

The CHAIRMAN. Thank you very much, Mr. Underwood.

Who is next?

Mr. BROUN. Would you gentlemen prefer to hear Governor Holland now or tomorrow morning?

The CHAIRMAN. We thought we would finish this afternoon with this subject.

Senator BARKLEY. Mr. Chairman, I want to make this suggestion: That this brief that Mr. Underwood has asked be passed around ought to be printed as part of the record. It is not very long, and I ask that it be made a part of the hearing record.

The CHAIRMAN. Very well. It may be incorporated in the record.

(The brief presented by Mr. Underwood is as follows:)

BRIEF SUBMITTED BY THOMAS R. UNDERWOOD, LEXINGTON, KY., SECRETARY NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

The proposal of the House Ways and Means Committee for a tax of 5 percent on pari-mutuel betting creates the illusion that revenue could be raised easily from a nonessential sport for necessary war expenditures. If this were the case, all who are interested in racing would be very unwise to offer any objection, because nothing would go further to perpetuate and popularize racing and, indeed, to lead to its promotion and, perhaps, expansion during a time of crisis. Already nearly all profits from racing, and particularly of the big days at all the tracks, are being contributed voluntarily to the war fund and are donated to designated Army and Navy relief organizations.

Winning of the war must come first above every other consideration. Conscious of this and unwilling to appear in the role of opposing any measure for the announced aim of assisting in the war program, racing and thoroughbred breeding interests may be unwilling to offer the objections that they otherwise would express to the adding of Federal taxes to the already high taxes the States now impose.

FOR ANYTHING TO WIN THE WAR, BUT FACTS SHOULD BE STUDIED

This attitude was well expressed in a letter by Beverley Broun, president of the National Association of State Racing Commissioners and chairman of the West Virginia Racing Commission, in a letter to Congressman Jennings Randolph, in which he said:

"First, I do not want to be regarded either personally or as a representative of racing interests in this State or racing at large, as opposed to anything that

would affect the raising of revenue to carry on the war, but I do submit that there are certain facts that should be taken into consideration to the end that these revenues may not be altogether destroyed by ill-considered legislation. I observed from the press this morning that the Ways and Means Committee is considering laying a 5 percent Federal tax on pari-mutuel wagering at race tracks. I realize that this committee is charged with a very, very difficult job in raising funds wherewith to take care of the immense obligations this Government is committed to, in waging an all-out offensive and defensive war and rendering assistance to its allies, and that every possible source of revenue should be tapped for this purpose. Notwithstanding, it seems to me that the Government might well overreach itself in laying taxes to the point whereby it destroys the source of revenue not only to the States but to the Federal Government as well. Of course, the revenue to this State has been materially curtailed by reason of the gasoline and tire rationing, and other related activities, and this State will definitely feel the loss of revenue from racing in the event Federal legislation is passed likely to curtail this activity."

A year ago, when a Federal percentage tax on pari-mutuel wagers was proposed to the House Ways and Means Committee, the objections to such a tax and difficulties in connection with it were outlined in a bulletin by the National Association of State Racing Commissioners. This association for 8 years has compiled tabulations on the total pari-mutuel turn-over of all the States having legalized racing and of the State revenue therefrom. The same arguments advanced a year ago against the addition of Federal taxes on pari-mutuel betting to the present State taxes still hold good, only more so.

GOVERNORS CONCERNED BY REVENUE LOSS DUE TO TRANSPORTATION

The other taxes, such as corporation and excess-profits taxes and individual income taxes that are paid by racing associations and by their owners and by the owners of racing stables and of thoroughbred breeding establishments, have vastly increased. The curtailment of transportation facilities has presented such a problem that Governors of some of the principal racing States in the East, concerned over the prospective loss of revenue, have held a number of conferences on that subject.

This curtailment also has caused anxiety to those endeavoring to raise funds for war relief to such an extent that in a letter to Governor Herbert H. Lehman, of New York State, Chairman Herbert Bayard Swope, of the New York State Racing Commission, also chairman of the Turf Committee of America that is sponsoring the war fund, indicated a possibility of difficulties in this task when he said:

"At the moment, as you know, racing, under the leadership of the Turf Committee of America, which comprehends all of the ramifications of the turf, including State commissions, the track operators, jockey clubs, the breeders and owners and trainers, is engaged in a drive to raise at least $2,000,000 for the national relief organizations, preferably the Army and Navy bodies. We will be able to do this if there is no interference with the natural flow of the sport."

Another factor altering the situation from what it was a year ago is that California has had a complete black-out of racing due to the defense program. The State of Florida has increased its percentage tax from 3 to 5 percent, on a sliding scale, to a tax of 8 percent and "the breaks," which will bring the total to about 9 percent. Clearly in so doing, Florida, whose taxing from racing go partly to advancing the social-security program, in undertaking the highest taxes ever attempted on racing, was endeavoring to find a source of taxes untouched by the Federal Government and tax it to the limit it could possibly bear.

Also to be considered are the amounts of purses offered for horsemen, their only income with which to maintain racing stables, which, despite increased costs, have not been advanced. This problem was emphasized by the recent "horsemen's strike" over the size of purses at Suffolk Downs.

REASONS WHY GOVERNMENT MIGHT BE "CATCHING BEAR BY TAIL"

From the statistics available, it is apparent to those who have observed closely legalized racing over a period of years and are familiar with its details that:

1. There is no chance of raising $25,000,000 annually in additional taxes from racing.

2. A Federal tax of 5 percent eventually will "dry up" the revenues which States are now receiving, which are of considerable value to those States receiving such revenues but would not make a large item in the Federal budget.

3. Any added taxes on top of the high taxes racing is now paying would drive betting away from the tracks to illegal bookmaking channels, making any worthwhile regulation all the more difficult.

4. Federal corporation and excess-profits taxes amounting to millions of dollars are now being paid by race-track associations and individual income taxes are paid by their owners, as well as Federal admissions taxes which are paid by patrons.

5. While most other proposed tax additions are increases that would not involve any change in taxing methods, a tax on mutuel betting would involve the Federal Government in an experimental innovation requiring costly supervision and inspection.

6. Outstanding and widely known stables, whose familiar silks have made American racing popular, and the best in the world would be inclined to drop out, leaving the Federal Government seeking revenues from racing that would be at the mercy of the racketeering and gambling elements that competent State regulation has sought to eliminate.

TABULATION ON STATE REVENUES AND PARI-MUTUEL TURN-OVER

Attached hereto is a copy of a tabulation, made by the National Association of State Racing Commissioners, showing the pari-mutuel turn-over and revenue by States for 1941 from thoroughbred horse racing.

For 1942 these figures will be considerably altered, in view of the fact that California has had no racing. Also, as noted above, Florida has increased the State tax to 8 percent and the "breaks." The "breaks" are the amount between what the return from the pool would be and the nickel or dime division that is paid back to the bettor by the track.

The National Association of State Racing Commissioners—Pari-mutuel turn-over and revenue by States for 1941 thoroughbred horse racing

State	Percent take-out permitted	Breaks	Pari-mutuel turn-over	State received		Tax method
				From pari-mutuel take-out	From licenses and taxes	
Arkansas	15 percent	5 cents	$3,727,367	$186,368.35	$33,850.70	5 percent pari-mutuel; $500 daily license; tax on admissions.
California (July 1, 1940, to June 30, 1941)	12 percent	10 cents	94,553,615	3,782,144.60	16,970.50	4 percent pari-mutuel; employees' licenses.
Delaware	10 percent	5 cents	11,438,113	400,333.94	53,377.40	3½ percent pari-mutuel; $3,000 per season license; 20 cents on admissions.
Florida (1940-41 season)	15 percent	do	42,948,398	1,288,451.94	175,108.25	3-5 percent pari-mutuel and breaks.
Illinois	10 percent; 11 percent Fairmont.	10 cents	60,007,214	1,080,082.72	730,099.69	Daily license $500 to $2,500; 2 percent pari-mutuel; 20 cents on admissions; employees' licenses.
Kentucky	10 percent	do	12,325,850		176,687.55	Daily license $500 to $2,500; also 15 cents of admissions.
Louisiana	13 percent	do	First race meeting under commission Dec. 25, 1941.			3 to 7 percent based on figures from $50,000 to $200,000 and over.
Maine [1]						
Maryland	Spring, 8½ percent; fall, 10 percent.	5 cents	41,852,667	1,552,268.70		1 percent pari-mutuel, $5,000 per day; 15 percent of net revenue at mile tracks.
Massachusetts	10 percent and 15 percent fairs.	10 cents	25,178,946	1,047,840.08	4,737.00	Daily license $400 ($10 fairs); 3½ percent pari-mutuel and 50 percent breaks; fairs ½ of breakage only.
Michigan	7½ percent	do	12,353,851	173,925.00		Tax on admissions; daily license $2,500.
Nebraska	10 percent		2,250,000	24,014.10	3,356.09	Daily license $200 (fairs $15-$50).
New Hampshire	11 percent	10 cents	19,254,484	1,004,863.39	13,512.20	4½ percent pari-mutuel and 50 percent breakage; association pays city $250 for each day of more than 8 days racing.
New Jersey	10 percent	5 cents	34,320	1,372.80		4 percent pari-mutuel.
New York	do		133,982,574	7,277,929.36	519,977.16	$25 per day; 15 percent on admissions; 5 percent on pari-mutuel, license fees.
Ohio	do	10 cents	8,182,550	130,305.00		10 percent first $1,000; 15 percent next $4,000; 20 percent next $5,000; 22½ percent next $5,000; 25 percent next $5,000; 30 percent all over.
Oregon	12½ percent	5 cents	393,919	10,508.26	1,312.40	3 percent pari-mutuel; daily license $100.
Rhode Island	10 percent	do	32,596,101	1,140,863.00		3½ percent pari-mutuel and license fees.
Washington	15 percent	do	3,925,132	196,256.60	8,748.00	5 percent pari-mutuel; daily license $100.
West Virginia (estimated)	10 percent	10 cents	8,000,000	113,000.00		1 percent pari-mutuel; daily license $250.
			513,005,110	19,390,437.84	1,737,736.87	

[1] Harness racing only.

TOTAL AMOUNT BET AND THE INTRICACIES OF "FRESH" MONEY

In any calculations concerning the total amount bet on all American race tracks it must be borne in mind that this is the combined total of the same money, passing over and over again, through the same pari-mutuel pool or clearing house. It is run through the pool or totalizator the same way clothing is run through the wringer, to be redistributed in full, except for the amount allowed by State laws to be deducted. This deduction, or "take-out," amounts to approximately 10 percent, as an average, among the States whose provisions on the limit differ. From this "take-out" the racing association must pay State licenses and the amount required by the State government in taxes, which is 3 percent in most States. The association also must pay the stakes and purses for which the horses run also from the receipts of those deductions from the betting pools.

In the very illuminating report of the New York State Racing Commission for the year ending 1941 some very interesting explanations are made in regard to what constitutes "fresh money."

On that subject the New York State report says:

"A rule of thumb that seems to have reasonable accuracy is to add the first-race betting to the last; add to that sum the "take" of 10 percent and the breakage on the entire handle and you will reach a rough approximation.

"If that rule is followed, we find that this year the first race shows a total of $8,000,000 bet; the last race shows $21,600,000 bet. Add to this $29,600,000 the total take of $13,325,000, plus the breakage of $1,010,000, and the full sum is about $44,000,000. This amount is about 33 percent of the total of $133,000,000. So, if this formula is right, about one-third of the total handle is actually brought fresh to the track. The ratio may be high, for the wagering money is bet and rebet several times in the course of the day."

The figures given in the New York report applied to New York's total wagering, but if applied to the figures for the country as a whole they will show that with approximately $513,000,000 as the total amount of all the money that was passed through the mutuels in 1941, if the New York Racing Commission's contention is true this was not really half a billion dollars but actually about $171,000,000 passing through the mutuels and redistributed to the bettors time and time again.

From this amount the States are now taking approximately $21,000,000 in taxes. From this amount the tracks are now taking about $35,000,000 annually, from which they must pay the purses to horsemen, estimated at about $17,000,000 annually, and all the expenses of the track. From this it is now proposed that the Federal Government take an additional $25,000,000 in taxes.

WOULD DRY UP THE SOURCE AND KILL GOOSE FOR EGGS

From this it will be seen that it would not take long to dry up the source by "killing the goose that lays the golden egg."

For the States which have legalized racing and where it is a principal sport this type of taxation furnishes a very effective sum in revenue. Racing touches a very limited area, restricted chiefly to metropolitan centers. The money that is raised from taxes on racing means a great deal to such States as New York, Massachusetts, Rhode Island, New Hampshire, Florida, Maryland, Illinois, and, before the black-out, California, but the town that it is possible to obtain from a tax on pari-mutuel betting will not be a large item in the Federal Budget.

Although the Federal Government does not now receive taxes from percentages on pari-mutuel wagering, it receives corporation and excess-profits taxes and taxes on admissions.

A tabulation made on the basis of 1940 taxes showed that these amounted to $3,192,354. In addition, the owners pay taxes on individual incomes received from ownership of tracks.

In his letter to Congressman Randolph, Chairman Braun, of the West Virginia Racing Commission, wrote:

"The Federal Government, as you of course know, takes a very large part of the proceeds of these tracks in the way of Federal income taxes, and in addition, taxes on admissions and various things sold and disposed of by the concessionaires.

"To illustrate, taking the small track at Charles Town in this State as an example. I quote from a letter written me on February 23, 1940, by Mr. W. S. Venable, auditor of the Charles Town Jockey Club, Inc.:

" 'From the standpoint of earnings, the year was a very good one ($228,236.91), but that is before the income taxes have been deducted. From the surplus account

in exhibit B you will see these amounted to $112,485 63 for 1941 and additional taxes of $6,664.63 for 1940, making a total of $119,150.46 for the Jockey Club to pay, in addition to which Mr. Boiye and Mrs Boyle will pay $95,914.81, or a total of $215,065.27 for the year, which just about takes all of the earnings of 1941.' "

In 1941, when the subject of a Federal tax on incomes was raised in Washington, Charles F. Adams, president of Suffolk Downs, submitted the following interesting table of income statistics for the year ending March 1, 1941, for the Eastern Racing Association, Inc., owner of Suffolk Downs:

Eastern Racing Association, Inc., income statistics

Operating profit before taxes		$1,513,299.06
Payments to State:		
3¼ percent of handle	$785,647.87	
50 percent of breakage	162,983.16	
Association license fee	24,000.00	
Registration and licenses	4,215.00	
Forfeitures	475.00	
Total	977,321.03	
Other tax payments:		
Real estate:		
Boston	73,043.46	
Revere	36,326.40	
Massachusetts excise	8,500.00	
Federal capital stock	6,241.40	
Federal old age	3,519.87	
Federal admissions tax	45,125.64	
Federal income	95,893.68	
Massachusetts unemployment	9,503.63	
Federal unemployment	1,055.97	
Total	279,210.05	
Grand total tax payments		1,256,531.08
Net profit after taxes		256,767.96

NOTE.—Five-sixths of operating income used for taxes, one-sixth of operating income available for stockholders. (The stockholders had to pay individual income taxes on what they received in this form.)

HIGHER "TAKES" AND TAXES MIGHT INVITE BOOKMAKING

The theory of legalized and regulated racing, with betting permitted only through the pari-mutuel machines, is to make the wagering feature incidental to the sport although the "take-out" from this source must furnish the money for purses and operations.

Illegal betting, of course, takes place covertly away from race tracks and neither the States nor the tracks receive any income whatever therefrom. The theory on which the amount of take-out possible must be figured must take into consideration the law of diminishing returns and the fact that all the betting which is now conducted legitimately and is controlled can be driven into illegal bookmaking channels.

If this is done the stables whose silks have stood for sportsmanship in American racing for many years would be less and less in evidence; leaving racing at the mercy of the racketeers and gambling elements.

GREAT CONSERVATION ACTIVITY—MANY ACRES NOW IN GRASS

The thoroughbred breeding industry is now America's greatest privately financed conservation enterprise. For producing thoroughbred race horses there are now in grass more than a hundred thousand acres in Kentucky and Virginia and a few other States in the East and many more in the Western States.

This land is being withheld from the cultivation of other crops, principally tobacco, of which there is a surplus. No Federal benefits whatever are paid on keeping this land out of production as a vital national resource. If this land were turned back into the production of crops now it would contribute to over-

production and greatly complicate the problem of crop control for the benefit of the farmers who already have serious price problems.

Only recently leading authorities on conservation have warned of the reduction in wildlife by the reclamation of swampland, which destroyed their natural habitations. It would be very unwise to invite the fate of the Dust Bowl for this land that is now in grass and that in some instances has never been turned to a plow.

At the present time, at the request of the Federal Government, hemp and hemp seed are being grown upon a considerable scale on those horse farms. This is done at a figure less than could be obtained by producing tobacco or horses. Sheep and cattle graze on much of this land, the wool output being a very essential war enterprise.

There are now 178 active thoroughbred breeding establishments in Kentucky on which there are advertised thoroughbred stallions and quite a number of farms on which there may be one or two mares as a sideline to other types of farming. California, the second most active breeding State, has 127 such farms and Virginia has 85; Illinois, 47; Maryland, 71; Ohio, 38; Texas, 98; New Jersey, 9; New York, 6; Massachusetts, 10; Tennessee, 8; Pennsylvania, South Dakota, New Hampshire, and Wyoming having lesser numbers.

While there are no statistics covering the total number of thoroughbreds foaled within the year on the 742 farms, the Jockey Club, with offices in New York City, registered 6,458 thoroughbred foals in 1941.

The following summary is contained in the report of the New York State Racing Commission:

"OTHER VALUES INVOLVED

"Thoroughbreds in this country include about 650 stallions; 12,000 mares, 10,000 head of young stock and about 25,000 in training. Additionally, there are polo mounts, remount stallions, thoroughbred chargers, etc., coming to a total of perhaps 9,000 head.

"THOUSANDS LIVE ON THE TURF

"About 20,000 farmers are required to raise the hay and oats needed for this stock.

"It is estimated that a staff of 10,000 is required to run the stud farms. This number, added to 4,000 trainers, 1,500 jockeys, 15,000 exercisers, swipes, hostlers, etc., plus 5,000 other employees such as mutuel machine operators, police, trackmen, et al., gives a total of something less than 60,000 wage earners kept going by the turf.

"If each represents a unit of 4, we have 224,000 men, women, and children dependent upon the racing industry for their livelihood. The pay roll of the turf is between fifty and sixty million dollars a year.

"The value of the farms, counting only those exclusively used in the production of thoroughbreds, is $20,000,000.

"The value of the race tracks in the United States including stalls and all exercise tracks and all other accessories is $75,000,000.

"The value of race horses is $55,000,000.

"The value of the farm lands used to produce the food is $10,000,000.

"This is the break-down of the estimate of $160,000,000 as representing the investment in the complete racing establishment of America.

"There are about 50 tracks in America of a mile or more in size. Reports show that there are as many more half milers."

HORSE BREEDING EXPERIMENT STATION FOR ALL BLOOD STOCK

Horse breeding and racing perform noteworthy service for this Government in other ways. They serve as pace setters and virtually an experiment station in the science of selective breeding, the principles of which have been applied to all other types of livestock. The thoroughbred horse was the first purebred animal put to the service of man, and the breeders of the other types of fine livestock which we have today copied and followed the technique which was the result of countless experiments conducted by the thoroughbred horse breeder.

Thoroughbred horse breeders have been leaders in the study of diseases which attack livestock, and now they are making it possible to serve mankind in another way. Dr. John MacLeod, a member of the staff of the anatomy depart-

ment of Cornell Medical College at New York Hospital, has just completed a month's stay in the horse-breeding section of Kentucky in the interest of furthering his work on sterility. He set up a laboratory at one of the large farms and studied the cases of stallions known to be sterile. He said that his hero would greatly benefit the work of his department with human anatomy. He referred to the horse-breeding section of Kentucky as "a vast natural laboratory which will serve mankind greatly if its resources are properly taken advantage of."

Aside from the loss that will befall thousands of persons who depend on horse breeding and racing for a living, any setback to racing and breeding will deprive this country of a place in the production of blood stock that has taken it scores of years to reach. In this connection, Mr. Arthur B. Hancock, one of the most successful of our horse breeders, has written:

"It has taken about 300 years to develop the thoroughbred horse to the present time when we are producing animals like Man o' War, Equipoise, Gallant Fox, Omaha, Whirlaway, Alsab, and the like. In my opinion, a few year's cessation of racing in the United States would undo most of the work that has been done by the thoroughbred horse breeders of all times and all countries.

"Due to the misfortune of war in England and in Europe, the United States has been able to acquire many of their best stallions and mares until today we have more great ones than any country in the world, and are in a position to produce the best horses of all time."

GREAT HORSES ARE GIVEN TO UNITED STATES REMOUNT SERVICE

It is proper to add that the improvement of all light horses, such as are used in our Armed Forces, and on farms for the lighter kind of work, has been due largely to the infusion of thoroughbred blood.

The Army horse-breeding program, through the United States Remount Service and the purchasing divisions that have been established, shows the need for thoroughbred horses for cavalry and general Army use, and if tire and gasoline rationing becomes more extensive many more horses will be needed for all purposes, especially on farms.

The contributions of horsemen to the Remount Service are already well known. Col. E. R. Bradley has given 35 stallions, including the Kentucky Derby winner, Behave Yourself, to the Remount Service. Joseph E. Widener, owner of Elmendorf farm, recently gave Plowshare, a full brother to Stagehand, to the Remount Service. He had previously given several other stallions. William Woodward gave Alcazar, the sire of Apache, to the Remount Service and he is now at Front Royal, Va.

It is generally agreed that half-breed horses by thoroughbred sires are superior for many light-horse tasks such as polo, hunting, cavalry, and general farm use. A reverse of this is being planned by the Thoroughbred Club of America in its program to have thoroughbred mares given to 4-H Club members in foal to draft stallions and jacks to increase the work stock on farms.

The Keeneland Association at Lexington, Ky., gives its profits for studies of animal diseases and pathology by the University of Kentucky.

The CHAIRMAN. All right, Governor.

STATEMENT OF HON. SPESSARD HOLLAND, GOVERNOR OF FLORIDA

Mr. HOLLAND. Mr. Chairman and Senators, I dislike very much to trespass on your time when it is so late. I have already missed my afternoon train, and I could stay over until tomorrow morning if you would prefer.

The CHAIRMAN. We have a full day tomorrow.

Mr. HOLLAND. I will be governed by your convenience.

The CHAIRMAN. You may proceed.

Mr. HOLLAND. This is a subject matter which, as is already apparent, has many different ramifications and points of view—not only that of the businesses that are involved, both the racing businesses themselves and the business of producing fine purebred horses, but it also has the question involved, which brings me here, of the effect

upon the fiscal policies of the States which have racing legalized and which have woven racing into their fiscal picture, so that—at least in the case of Florida—it has become a very, very vital part of the entire picture.

I would like to say, in the first place, that nothing but that fact would bring me here, when I know that you are puzzling in every way that you can to raise war revenue, and nothing but my feeling, in the first place, that here is a field that, by its very nature, should be left to the States, and in the second place, that the imposition of this tax would leave my own State in a critically harmed condition as to its financial policy.

Nothing but those two convictions would bring me here before you.

In the first place, on the general question of the nature of this field of taxation, this is a business which operates in no State as a matter of right, but operates under special license, franchise sufferance, by States which have found that, in the judgment of those States, the sport is one which they feel will add to their attractiveness as a whole.

Not nearly all of the States have so found, and only 19 are now in a position of operating legalized racing. They are affected in varying degrees.

I believe that no State is so heavily affected as the State of Florida, by which I mean not that the State of Florida has the largest total take in dollars, but that the total take which we have in Florida from racing represents a larger proportion of our total budget than is the case in any other State.

I make that statement as a matter of absolute fact, reserving only two States—New Hampshire and Rhode Island—and I reserve them because I don't have the figures as to their entire budgets.

The amounts which they take out of racing in each case are about a fourth of that taken by the State of Florida, but I don't know how their entire budget would compare with ours.

Senator BAILEY. What was the amount of revenue from racing?

Mr. HOLLAND. $4,390,000 represented receipts in our State from racing in the 1941–42 season.

Senator BAILEY. What is the total revenue from the State?

Mr. HOLLAND. The total revenue from the State, exclusive of such funds as unemployment compensation and funds like gas tax, for road maintenance only, is about seven times that. In other words, this is about one-seventh of the total revenue of the State, excluding funds of the type I have mentioned, and that includes the three general classifications of funds which are general, operated under our taxes: (1) The general revenue fund, under which we pay general operating expenses of the State; (2) the State welfare fund under which, when it is augmented by Federal funds, it pays old-age assistance, aid to dependent children, aid to the blind, and so forth; and (3) our State aid to the school system, which is on an $800 per instruction unit basis covering the entire State.

Those are our three largest operating State funds, and the total of them is about $28,000,000—between twenty-eight or thirty million dollars—making the total that we derive from racing about one-seventh of that total.

Senator BAILEY. Do you have a sales tax?

Mr. HOLLAND. We do not have a sales tax; and, since you bring up that point at this time, although I had saved it for a later time, I want to say that, while our situation may not be representative of that of oher States, each State is bound, in is own judgment, to determine the policies which best suit its businesses and its people, and under our set-up we have followed the policy of segregation of various sources of revenue so as to admit of as few duplications of taxing power against the same source as may be possible.

For instance, the State has entirely abandoned the field of income taxation, leaving that to the Federal Government; that is by constitutional provision.

Likewise, we at one time entirely abandoned estate or inheritance taxation and then amended our constitutional provision simply to admit of the taxing of estates in the identical amount that the Congress of the United States might allow from time to time as a credit to taxpayers of inheritance tax upon their Federal inheritance tax.

Likewise, as a matter of State policy, we have never favored, and we have never adopted, a consumers' sales tax or a general sales tax of any kind, and have stayed away from the nuisance taxes customarily found, such as cigaret taxes, cosmetics taxes, moving-picture taxes, soft-drink taxes, and the like, feeling that those taxes can best be handled on a Federal or Nation-wide basis.

Then, as an additional matter of our segregation of tax sources, the State has relinquished, by constitutional provision, any right to receive property taxes from real estate or from tangible personal property.

Those sources are reserved for taxation by the counties, the districts, and the cities, and that leaves the State dependent upon excise taxes, privilege taxes, and taxes that fall within that general classification for operating expenses.

So that, in our condition, we would have to replace this $4,390,000, under our constitution, by taxes which would single out some forms of business, at a time when most of our businesses are gasping for air anyway, just like they are in the other States, and they are willing to take their share and to carry their part of the burden, but the idea of trying to place nearly four and one-half million dollars more, in a State the size of ours, upon some business or group of businesses, by an additional privilege or excise tax, is one that is not only quite abhorrent to me but, because of the method of distribution of this particular tax, it is impossible of accomplishment in our State without a constitutional amendment.

When the race tracks were first legalized in the State of Florida, it was done under the theory that race-track revenue could be divided equally among all the counties—we have 67 counties—and that provision was written into the racing law.

Shortly thereafter, upon a test of a similar provision affecting certain gas taxes, our supreme court held that that was an unconstitutional basis of distribution, because it allowed a county like Dade, with nearly 300,000 people only, the same amount as a county like Glades with only 150 people, and without any relation at all to the amount of the tax that came from the people of the respective counties.

So, in order to meet this situation on the race-track proposition, it was necessary to offer for adoption by the people—and the funds were in the meantime impounded; it led to a very great feeling and big

battle in our State—a constitutional amendment which was incorporated into the constitution at the general election in November 1940, and which determined that all or any part of the funds derived from racing might be divided, in the judgment of the legislature, equally between the 67 counties, and all of the old tax—the tax that existed prior to the 1941 session of the legislature—was divided on that basis, and that amount is still divided on that basis, because the new taxes set up in the 1941 legislature, to which I shall refer in a moment, guaranteed that the counties would not be hurt in their participation in this fund, which would be equally distributed among them by this new added tax or take.

Senator CONNALLY. Are these tracks located mostly at resort places?

Mr. HOLLAND. Mostly at resort places. Most of them at Miami.

Of the nine dog tracks, six are at Miami, one at Hollywood, one at Orlando, one at St. Petersburg. As you see, most of them are in the resort areas as well.

I brought for insertion in the record printed copies of the constitutional amendment, which leaves us in the position where, if we had to try to undo the damage done by this thing, that we think would be done, we would have to proceed first by the submission of a constitutional amendment—a rather laborious process under our constitution—and it would require more than 2 years' delay before we could put ourselves in a position to undo the damage, so that the point is illustrated, which I made in the beginning, that here is a matter which peculiarly belongs to the local communities which have thought fit, in their judgment, to set up and legalize racing.

In our State it is not only regarded as something that the State can set up, but it is even left to the local option of the county affected, and no racetrack can be set up until the county, by a local optional election, has legalized racing for that particular county.

So here we have a fund which in our State has become a very important part of the total income of the State and which by its disturbance at this time would leave us—at a time of great difficulty, as we all are, all the States—leave us with an impossible problem of solution, impossible of solution at least until a constitutional amendment could be submitted and passed, upon which, as I say, now would require 2 years under our State constitution.

Senator LA FOLLETTE. What effect so far has the rationing of gasoline had upon your State revenues, if any?

Mr. HOLLAND. It has had a tremendous effect, and we are not here to complain about that.

Senator LA FOLLETTE. I thought it bore some relation, if you are suffering under a loss of that revenue, if you felt that you are suffering an additional loss in contemplation of this proposed tax.

Mr. HOLLAND. We are, and I am glad you asked the question.

Last month the State of Florida suffered a loss of $586,000 of its gas-tax revenues, as compared with the same month a year ago, which is a very heavy loss.

In addition to that loss, while I am on that—and which we are not mentioning here, because we realize we have got to take our licks on the chin, just like every other State—we have suffered a heavy loss in two other places where our State revenue comes from as a result of the war already, and we will probably have more.

One of them is from our documentary stamp tax. Our documentary stamp tax, about half of it, came from stamps that were used on retained-title contracts and chattel mortgages and the like, in connection with the sale of automobiles, radios, Frigidaires, washing machines, and all of those things, which have been banned by the war program, and we have taken a heavy loss there.

In addition to that, one of our other heavy sources of State revenue is an excise tax on electric current, and, of course, we happen to have around 2,000 miles of shoreline, and all of our cities except one or two are located on the shoreline, and all of them have been dimmed out, and, while I don't have the exact figures, I do know, from personal conference with the heads of the two largest companies in the State, that we will suffer a tremendous loss there.

That tax is payable annually, in February of each year, so there is no chance yet to see how great that will be.

With those losses, and others, already sustained or facing us, it seems to me that this matter, which after all depends on the grace of the State—our State or any other—as to whether it exists, and exists only in the form that is permitted by the State law, this matter, it seems to me, is a matter which should be reserved to the States and subjected only to their taxing powers.

Senator BAILEY. Do you have an income tax?

Mr. HOLLAND. No, sir. We have a constitutional provision banning income tax.

Senator BAILEY. State tax or inheritance tax?

Mr. HOLLAND. None except what is allowed by the 1928 act—I believe it is—as a credit on Federal tax.

We had, prior to that time, if you will recall, an absolute ban on any inheritance tax, and after Congress had passed a law allowing an 80 percent credit upon the then payable tax, it took us 3 years to amend our constitution so that we could get ours in shape to claim that credit.

Senator BAILEY. How much did you get, say in 1940, from the W. P. A.?

Mr. HOLLAND. I am not able to answer that, Senator.

Senator BAILEY. What is the national contribution to social security?

Mr. HOLLAND. We were treated generously, and the Federal Government in general has treated us generously and fairly, but at the same time I don't know how they could undo the damage which I think would be done by this measure, because they can't change our constitution, and they can't replace these funds if taken out.

Now, the added 5 percent take which was added as against horse tracks in the 1941 legislature, and which made available over $2,000,000 last year, over and above what we had received before that—that is included, however, in the $380,000—that goes to old-age assistance and, of course, is matched by a similar amount from Federal funds.

I can't think of anything in our State just now where we would with greater reluctance retract our program, diminish benefits, than in the case of the aged, who are about the only people in our State who can't work now, because we haven't got any need of any consequence at all now for taking care of the unemployed in our State, because we have so very much of the activities going on there now,

enabling people who have been unemployed to be employed, but, if we are hit on this racetrack business in such a way as to diminish or to knock out this fund, I call attention again to the fact that something over $2,000,000 of it, that goes to the counties, can't be replaced in the way that it is now distributed, and more than 40 of our counties get 40 percent or better of their entire operating expense from this money which they get annually out of this even split; that can't be done until a constitutional amendment is passed.

As to the nearly $2,000,000 that goes to old age, why, of course, we are left there where we just simply have to transfer that to something else, which I presume we could do, but which means hitting business somewhere.

I wanted to file here in evidence this map, prepared——

Senator BAILEY (interposing). Did you have a surplus or deficit at the end of your last fiscal year?

Mr. HOLLAND. We had a surplus of a little over $800,000. We are operating on a balanced budget and we are trying our very best to stay in that condition.

I had the State planning board prepare this map illustrating—and I won't take your time to go into it in detail here except to tell you the substance of what is shown by it—how each county of our 67 depends upon this even split, this even break, out of something over two million of the race-track money.

There are many counties, of course, which are affected in a negligible way.

Such counties as Duval, where Jacksonville is, or Dade, where Miami is, which represents only a small part of their total budget, but there are 40 counties or more as to whom 40 percent or greater—and it goes up to 80 percent, on some of the smaller counties, of their entire operating budget, of their general county fund spent by their county commissioners, or 40 percent or more of the same fund for schools as spent by their county school board, or both, in some cases, comes out of this particular even break of the racing revenue.

Senator CONNALLY. What part of the money do you give to the counties?

Mr. HOLLAND. We give to the counties the revenue which was operative before this new act was passed, and that comes out to something over $32,000 per county per year.

Senator CONNALLY. I know, but it is a State tax: you don't give it all to the counties, do you?

Mr. HOLLAND. No, sir. We give to the counties the entire tax that was levied before 1941 legislature. At that time the entire taxes levied were 3 percent of the amounts wagered at both classes of tracks, both horse and dog tracks. The last legislature added 5 percent tax on the horse tracks.

Up to that time the complete take against money wagered at the dog tracks had been 15 percent, of which 3 went to the State and 12 went to the track.

At the horse tracks it was 10 percent, of which 3 went to the State and 7 went to the tracks.

We added on 5 more at the horse tracks, making them a total take of 15 plus. By the way, the breaks, which we also take now, and that last tax added on, then, is what goes to the old-age fund, Senator,

whereas the entire tax as levied prior to 1941 still goes to the counties, and in order to reassure them that they would not be hurt by this last tax added in 1941, we guaranteed their continued receipt of the amounts which they had received in the last year prior to that, out of the general picture, which figures to thirty-two or thirty-three thousand dollars per county per year.

Senator BARKLEY. Your last act practically doubled the amount the State received?

Mr. HOLLAND. Yes, sir.

Senator BARKLEY. And that means that practically half of what you now receive goes to the counties?

Mr. HOLLAND. That is right.

Senator BARKLEY. And the other half remains in the State and is devoted to the old-age pension?

Mr. HOLLAND. That is right. That is an approximation of the picture.

Let me say at this time that the question of what is the heaviest tax that the traffic will bear is something that I won't presume to say, except that, in our State, from the beginning of our legalization, we have assumed that this was a type of business which should be taxed to the point beyond which it couldn't be taxed without destroying its prosperity or its chance to live fairly, and so, as we believe strongly, we have taxed up to the saturation point at this time. Some of our good people think we have exceeded that point.

Mr. Swope, who has preceded me, is of that opinion. I don't share that opinion, but I think it is a debatable question.

Certainly we have gone to the ceiling of taxation, as we regard it, and we did sustain some losses in this last year as compared with prior years.

Senator LA FOLLETTE. Is any part of that due, Governor, to a lessening in the tourist business?

Mr. HOLLAND. Some was due to that. You see, our season was on just when Pearl Harbor came—followed it immediately.

Some was due to the fact that gas rationing was put on right in the midst of our season, and then, as dim-outs began to be ordered, some people began to be fearful and thought we were about to be bombarded or bombed at any time, and they left.

Some of it, in my judgment, is due to that, but it is at least a debatable question.

Coming back to the point I first made, it seems to me that here is a business which each State must judge, as to how heavily it can be taxed and still live, and that each State has tried to do that in setting up its tax.

I believe I have discussed this subject frequently with other legislatures, with other Governors. I was a member of the State senate in Florida for 8 years prior to the time I became Governor. I discussed it with Governor Saltonstall, with Governor Blood, with Governor O'Conor—the Governors of other States affected—and they all agree with me: (1) That they will be badly hurt; (2) that it is a matter peculiarly within the purview of State taxation; (3) that in each case they have woven the revenue which they have become accustomed to receive from this source into their entire fiscal picture and it would cause grave hardship on them to have the thing destroyed, or practically so, at this time.

As to whether it has been destroyed, I don't know, but I do know that the racing people are confronted with the gravest kind of problems, irrespective of this:

The local transportation problem is grave, the general transportation problem, in our case, is very grave, because as already brought out by you, Senator, our tracks are largely in tourist areas, and then in addition to that, the tracks which operate at night are affected by this dimout regulation, so that they have any number of problems which are heavy problems, and they are showing excellent spirit. Without exception they are willing to try to—even though some of them think they are going to take a loss this year, without this added 5-percent tax—and I want to say my hat is off to them. They are showing a splendid spirit in this thing, so far as those tracks in Florida are concerned—but I believe that to add this particular hardship now would just be killing the goose that laid the golden egg, not helping the Federal Government, and hurting us very badly, and I know from talking to these other governors, that they are of the same opinion with reference to their own States.

I talked to Governor Johnson at the Ashville Conference of Governors on this same subject.

Gentlemen, I am taking too long, but I would like to mention one or two other points.

One of those points is that this act runs right into a problem which we found last year is a grave one, and which in my judgment would completely defeat the intention of those well-intentioned gentlemen who wrote this provision into this proposed law. Incidentally, they are not in the Treasury, I don't know who put it in there; but that is the problem of the bookies, as I mentioned a little while ago. When we added the 5-percent take on the horse pool, at once the bookie problem, which had already been grave enough, became infinitely greater.

We set up not only a large number of inspectors under the racing commission, but I had private inspectors that nobody knew about except myself, because I felt like, when the racing people were trying their best to meet a situation which they thought was a grave one, that the least I could do was to try to free them from the bookie evil, and I think that they would say that we came as near doing it as was humanly possible.

However, we had a limited area, not comparing in population or extent with the situation, for instance, in greater New York or Baltimore or greater Boston, or any of the other metropolitan areas where racing takes place, and we found that it was a tough problem, with the State on the job there and with a stake in it.

Now, under this condition here, as this is drawn, the Federal Government would have no right to take a tax against the bookie. He doesn't operate a pari-mutuel, he doesn't have a totalizator.

On the contrary, he makes his own odds—they are better than the pari-mutuel and the totalizator odds, because he doesn't have the expense that they have.

You don't make that illegal. You throw every inducement on taking the funds out of the pari-mutuel and reducing the funds, to your own hurt and to the very great hurt of the States that would be

affected, and in many of the cases of the other States those bookies could operate just as well across the State line.

I could show you that, in thinking of the tracks, you would think of those conditions as within the State itself, where the track is located, due to the smaller size and the closeness of the State lines, in the case of many of the other States that have racing.

In my judgment that problem, the problem of putting a premium on dishonesty, and of throwing this thing to the bookies, would in advance doom this program to failure, and at the same time strike a very grave blow at the States, because, in order to get any revenue out of it, the States have got to have those bets carried through pari-mutuels.

The amount involved with us—$4,392,000—and the method of its distribution are sufficient to make this problem one of the gravest with which we have been threatened, and if I didn't feel it would be highly destructive to our situation I wouldn't be here to plead the case of the State of Florida and the case of decent racing as well as of the industry of breeding which lies behind horse racing at this time.

To us the imposition of this tax would mean a grave calamity, and we don't think it is fair, because it is just like picking out—for instance, suppose you had a sales tax written into this bill, and you picked out the product of our citrus groves but exempted the product of the apple orchards or some other agricultural industry: it hits a few States; it hits them in a hurtful way; it hits them in a field where they have already, in their own judgment, rendered a verdict as to how much tax the traffic will bear and they have imposed that.

Let me say that that rate is a differing rate in various States.

In our State, for instance, we depend largely upon the tourist industry.

People are there at the tracks just a few days, and move on.

Likewise, they are there in a playtime mood, and generally with considerable money in their pockets to attract its playing.

To residents, night after night, for the whole season, there is an entirely different situation, and we have seen that situation worked, and we have seen the contrast, for instance, between the horse tracks, who play to the tourists, and the dog tracks, who play to our own people.

Now, as to what is the maximum tax that can be fixed is a varying matter in varying States, and I think that the legislatures of those States, and the people of those States, have in each instance that I know anything about tried to fix the rate of taxation at the rate which they think is the highest that the traffic can safely bear and the business go ahead in a decent and profitable way.

Feeling that way about it, naturally I could do no less than come here and state this situation to you gentlemen.

Senator BAILEY. What do you derive from the sale of liquor in your State?

Mr. HOLLAND. Last year, $5,900,000.

Senator BAILEY. That is through licenses?

Mr. HOLLAND. Through stamps and licenses. That beverage money is included in two of the funds that I mentioned to you awhile ago. One of them, the first $3,400,000 of old age comes from the beverage tax, and the rest the school fund. The rest of that goes into the

school fund. That is not an added amount to the amount we mentioned awhile ago.

Senator BAILEY. Take out your race-track tax and your liquor tax and you would run the State on that $3,000,000?

Mr. HOLLAND. We would run the State on about $12,000,000, plus what we put into the old-age pension, which isn't strictly operating expense of the State.

Senator BAILEY. You would get at least ten million from income, wouldn't you?

Mr. HOLLAND. That, of course, would depend on how heavy the Federal income tax was, and what our experience was under it.

Senator BAILEY. North Carolina got twenty-two million last year from income?

Mr. HOLLAND. Yes, sir. Each State, of course, has determined its own fiscal set-up, and unfortunately with us the power to adjust ours to a new situation, in the case of this particular tax, is so delayed—it takes so long.

Senator BAILEY. So far as the merits of this question are concerned, I will dismiss that part of it, but in times past, when we let each State determine its own tax policy—we can't accommodate ourselves to the State policies.

Mr. HOLLAND. So far as Florida is concerned, it has shown its willingness to recognize that other governments have to live.

It has left inheritance taxation; it has left income taxation; it has left sales taxation; exclusively to the Federal Government—sales tax in all its ramifications.

Senator BAILEY. They have asked the Federal Government for so much money, and the Federal Government must sooner or later set its house in order, and we have to look in that direction.

Mr. HOLLAND. You are preaching a doctrine that I have preached repeatedly: that Florida, as one State, can't look to the Federal Government in these troublous times for its money, and we are not doing it and don't propose to do it. We want to keep our house in order, and we are just calling attention to the serious implications of this matter, which affects only us and a small group of the States, because 4 or 5 of these 19 are not materially affected, and we think that, as to them, this tax should be left to them, particularly in our case, where we have nothing to look to but license taxation, privilege taxes, to operate the State government on.

The CHAIRMAN. Thank you very much for your appearance.

Mr. HOLLAND. Thank you for your courtesy, gentlemen.

(The following documents were presented by Governor Holland to be incorporated in the record:)

COMMITTEE SUBSTITUTE FOR HOUSE JOINT RESOLUTION No. 45

A JOINT RESOLUTION

Proposing an amendment to article IX of the constitution of the State of Florida, relating to taxation and finance, by adding thereto an additional section authorizing the Legislature of the State of Florida to allocate and distribute to the several counties of the State, certain excise taxes now levied and collected and to be hereafter levied and collected by the State of Florida

Be it resolved by the Legislature of the State of Florida, That the following amendment to article IX of the Constitution of the State of Florida, relating to taxation and finance, by adding thereto an additional section to be known as section 15 of said article IX, authorizing the Legislature of the State of Florida to

allocate and distribute to the several counties of the State, certain excise taxes now levied and collected and to be hereafter levied and collected by the State of Florida, is hereby agreed to and shall be submitted to the electors of the State of Florida for ratification or rejection at the next general election of Representatives to be held in 1940, as follows:

SEC. 15. The legislature shall have the power to allocate and distribute to the several counties of the State, in equal amounts, and at such times as the legislature shall determine, any portion of or all excise taxes now levied and collected, or hereafter levied or collected, by the State of Florida from the operation of pari-mutuel pools.

Filed in office of secretary of state, June 12, 1939.

Summary of revenue receipts and disbursements, Florida State racing season, 1941–42

Revenue receipts:		
Horse racing:		
Tax on attendance	$120,105.27	
3-percent commission on pari-mutuel sales	1,162,056.72	
5-percent commission on pari-mutuel sales	1,936,761.20	
Tax on breakage	253,599.10	
Total, horse racing		$3,472,522.29
Dog racing:		
Tax on attendance	$122,782.62	
3-percent commission on pari-mutuel sales	703,408.08	
Total, dog racing		826,190.70
Jai-alai fronton:		
Tax on attendance	$19,369.94	
3-percent commission on pari-mutuel sales	42,582.75	
Total, jai-alai		61,952.69
Total, all associations		4,360,665.68
Receipts from occupational licenses	$27,854.25	
Receipts from greyhound registrations	3,063.00	
Receipts from assumed names and color registrations	1,163.00	
Receipts from miscellaneous sources	97.32	
		32,177.57
Total receipts, 1941–42 season		4,392,843.25
Cash on hand July 1, 1941		32,621.30
Total available		4,425,464.55
Disbursements:		
67 counties, at $31,792.93 each		2,130,126.31
3-percent handling charge for general revenue		131,785.85
Operating expenses		226,912.20
Old-age assistance		1,901,852.13
Cash on hand for expenses, June 30, 1942		34,788.06
Total disbursements and cash on hand		4,425,464.55

Summary of revenue receipts and disbursements for the general revenue fund, State welfare fund, and State teachers' salary fund for the fiscal year 1941–42

General revenue fund:		
Cash balance July 1, 1941		$560,590.70
Total receipts, fiscal year 1941–42		11,382,698.66
Total available		11,943,289.36
Total disbursements, fiscal year 1941–42		11,118,937.03
Cash balance June 30, 1942		824,352.33
Total		11,943,289.36
State welfare fund:		
Cash balances July 1, 1941:		
Old-age assistance and aid to blind	[1] $134,627.81	
Aid to dependent children	248,071.87	
		382,699.68
Revenue receipts:		
Old-age assistance and aid to blind:		
U. S. Government	[1] 3,549,878.32	
State	5,301,852.15	
		8,851,730.47
Aid to dependent children:		
U. S. Government	[1] 646,844.80	
State	667,799.61	
		1,314,644.41
U. S. Government for Administration	[1] 203,125.95	
Miscellaneous receipts	26,767.71	
		229,893.66
Total available		10,778,968.22
Disbursements:		
Old-age assistance		6,509,929.80
Aid to blind		465,342.00
Aid to dependent children		1,248,721.00
Administrative expense		1,142,504.66
Total		9,366,497.46
Balances end of month:		
Old-age assistance and aid to blind		1,165,967.17
Aid to dependent children		246,503.59
Total cash		1,412,470.76
Total		10,778,968.22
State teachers' salary fund:		
Cash balance July 1, 1941		498.12
Revenue receipts, 1941–42		13,379,830.54
Total available		13,380,328.66
Disbursements:		
Teachers' salaries	$11,406,870.00	
Transportation	1,385,464.00	
		12,792,334.00
Transfer to general revenue fund		587,954.07
Cash balance June 30, 1942		40.59
Total		13,380,328.66

[1] U. S. Government matches only after expenditures are made.

MEMORANDUM BY FLORIDA STATE RACING COMMISSION IN OPPOSITION TO TAX ON PARI-MUTUEL WAGERING

To the Honorable Chairman and Members of the Committee on Finance of the United States Senate:

The Florida State Racing Commission desires to file this memorandum brief with your committee in opposition to the enactment of subchapter D, tax on pari-mutuel wagering, being sections 1730 et seq. (sec. 616) of House bill 7378 of the Seventy-seventh Congress, second session.

The proposed Federal tax of 5 percent on pari-mutuel wagering will affect, in Florida, two horse tracks, nine dog tracks, and one jai-alai (fronton), and will affect similar activities in 17 or 18 other States where legalized racing exists.

In support of said opposition, the commission wishes to present for your consideration the following points, to wit:

First, this tax affects only 19 of 48 States and is properly a State source of taxation.

The proposed legislation does not generally affect the States, pari-mutuel wagering being only legalized in 19 of the 48 States. Said pari-mutuel wagering is a local State matter, set up and existing under special license or sufferance, and in Florida the law requires that in addition to approval by the State, the several counties must first, by local option, approve same. Therefore, we feel that a pari-mutuel tax is properly within the zone of State taxability and does not belong to the Government.

Second, Florida has imposed the maximum tax that pari-mutuel wagering can sustain and survive.

Pari-mutuel wagering, being a local State matter set up and existing under special license or sufferance, is now taxed by the various States where same exists as heavily as the activity will permit and still prosper. This is certainly true in Florida for the reason that Florida has imposed by law a "take" of 15 percent which includes the State tax, on all pari-mutuel racing at dog tracks and jai-alai (fronton) since its legalization. Florida imposed a take of 10 percent, which included the State tax, on all pari-mutuel wagering at horse tracks until 1941, when the State stepped up or increased its tax, which resulted in an increase of the take to 15 percent plus the breaks upon pari-mutuel wagering at horse racing, which we believe is the highest tax that racing can sustain. We are firmly of the opinion that racing in Florida cannot stand a higher tax than that now imposed by the State, and many of our people doubt whether pari-mutuel wagering at horse racing can sustain a take of 15 percent plus the breaks and racing still survive. Incidently, the tax which can be sustained in Florida could not necessarily be sustained in other States for the reason that Florida is a resort State where vacationers frequent, quite often for short stays, with their pockets full of money, looking for excitement, entertainment, and pleasure, and are more willing to pay a higher tax for their amusement; and in addition to this, there is a constant turn-over of the people with new money patronizing racing in Florida, while in the other States racing depends primarily upon the permanent residents in the territory surrounding the racing establishment; and for this reason racing could not prosper with so great a tax as that imposed in Florida in States depending upon a permanent or fixed population. Therefore, we believe that each State has taken into consideration the peculiar circumstances and conditions surrounding racing and pari-mutuel betting in its own territory and is, consequently, the best judge of the maximum tax that racing can sustain and still prosper; and, if racing is to survive, we sincerely believe that the tax upon racing should be left exclusively to the various States.

Third, pari-mutuel tax in Florida contributes one-seventh of the State's total revenue (exclusive of road and unemployment compensation funds), which revenue cannot be replaced without a constitutional amendment.

Florida derived from the tax on pari-mutuel wagering, during the past season, 1941–42, $4,392,676.51. This sum was distributed as follows: $2,130,126.31 on a pro rata basis to the 67 counties of the State, each county receiving as its pro rata share $31,792.93; to the State general fund, $131,785.85; to the State old-age assistance tax fund, $1,901,852.15. The moneys collected for tax on pari-mutuel wagering amounts to one-seventh, or approximately 14.3 percent, of the entire operating revenue of the State of Florida (excluding road and unemployment compensation funds). Under and by virtue of article 9, section 15

of the Constitution of the State of Florida, as amended, the legislature was authorized to allocate and distribute to the several counties of the State, in equal amounts, such excise taxes now or hereafter levied and collected by the State of Florida from the operation of pari-mutuel pools, and pursuant to said amendment, which was adopted at the general election in 1940, the legislature, in the 1941 session, did allocate and distribute to the several counties the entire revenue derived from the 3 percent tax imposed on pari-mutuel wagering. There are 67 counties in the State of Florida and in 36 of these counties approximately 40 percent or more of the local general budget or school budget, or both, comes from this source, and it is impossible to replace this revenue by any other excise tax or taxes for the reason that prior to the constitutional amendment above cited, the State did not have the legal power and authority to distribute the moneys derived from pari-mutuel wagering equally among the counties.

If the proposed 5 percent Federal pari-mutuel tax should be passed and the imposition of same result in preventing racing from operating in Florida or seriously curtail the revenue of the State derived therefrom, then each and every county of the State would be seriously affected and the State could not replace the moneys now received by the counties for the reason that in order to impose an excise tax to replace the tax derived from pari-mutuel wagering and distribute same equally among the counties, a constitutional amendment would be required, and this could not be enacted and become effective for a period of approximately 2 years from the convening of the next legislature in 1943. In addition to the 3-percent tax allocated to the various counties, a 5-percent tax plus the breaks on pari-mutuel pools at horse racing, is allocated by act of the legislature to the State old age assistance tax fund. As hereinbefore stated, this sum amounts to $1,901,852.15 and could not readily or easily be replaced by some other or additional excise tax. You can readily see that the proposed legislation now pending before this committee, levying a 5-percent tax on pari-mutuel wagering, will, in the opinion of the Florida State Racing Commission, be disastrous to the financial structure of the State of Florida as it now exists, and which can in no wise be remedied without a complete change in the financial structure of the State, which change would have to be the result of an amendment to the Constitution of the State of Florida.

Fourth, the general revenue of the State of Florida has already been adversely affected to a serious extent by existing war conditions.

The general revenue of the State of Florida has heretofore been seriously affected and will continue to be further affected by severe losses in revenue as a result of the war conditions, such as:

(*a*) By the diminishing of the revenue from the gasoline tax by reason of the shortage of rubber and gasoline, which, during the month of July 1942, as compared with the month of July 1941, amounted to in excess of $586,000.

(*b*) The decrease in revenue derived from the utilities tax, in which a great loss has been sustained by reason of dim-outs, black-outs, and other curtailments upon power consumption and other measures due to the war emergency.

(*c*) The decrease in revenue derived from State documentary stamp tax, the cause of the losses from such revenue being the elimination of installment contracts on refrigerators, radios, washing machines, electric and gas ranges, automobiles, gas heaters, and other personal property purchased on the installment plan, which said installment purchases are, in effect, prohibitive under present war emergency provisions and authoritive orders of the various departments and bureaus of the administration due to the present emergency.

Fifth, the fiscal policy of the State of Florida has been to eliminate State tax on real estate and tangible personal property and leave other sources of revenue, such as income tax, inheritance tax, general sales tax, etc., to the Federal Government. If pari-mutuel tax derived by the State is lost by virtue of Federal tax, there are few, if any, taxable sources available to the State.

Under the present constitutional and statutory provisions of the State of Florida, the fiscal policy of the State of Florida has been to do away with an additional tax on real estate and tangible personal property, leaving this source of revenue to the counties, cities, and districts of the State. The fiscal policy of the State of Florida has also been to leave to the Federal Government such sources of revenue as income tax, inheritance tax, general sales tax, and nuisance taxes, such as tax on cigarettes, soft drinks, cosmetics, theater tickets, etc. The policy of the State

of Florida is materially different from the majority of the States which levy such taxes and are, therefore, benefited from the revenue derived therefrom. It will, therefore, readily be seen that if the result of the proposed legislation is to deprive the State of Florida and the various counties thereof of the revenue now derived from tax on pari-mutuel wagering, there is no other source from which such revenue can be obtained and would leave the State and the various counties without means of carrying on and performing their governmental functions.

Sixth, the proposed tax does not apply to bookmaking and other forms of gambling and encourages an evasion of the law, which would destroy legalized pari-mutuel wagering and racing.

The proposed legislation, as will be seen, proposes only to tax pari-mutuel betting. In other words, this does not in any wise levy any tax upon individual bookmaking and other forms of unauthorized wagering. Therefore, the result would be that if a high tax is placed upon pari-mutuel wagering, the bookmaker would be able to lay or give better odds than the bettor would be able to obtain through pari-mutuel wagering, and as a result, the majority of the bettors would be encouraged to place their betting through the bookmaker rather than through the pari-mutuel windows. The result of this would undoubtedly be to encourage dishonesty and violation of the State law, which, even under existing conditions, is most difficult to control; and if bookmaking is encouraged and necessarily prospers, the result would be that pari-mutuel wagering would decrease and racing could not exist. If it be suggested that the proposed legislation be amended so as to include betting or gambling, if you please, on all racing or other sporting events, whether through pari-mutuel wagering or otherwise, the result thereof would not be entirely satisfactory from the standpoint of the Federal Government, by reason of its inability to detect the same and to collect any substantial part of the revenue thus provided, and the Government would not be materially benefited thereby.

Seventh, racing is already heavily burdened and handicapped and cannot survive the additional burden of the proposed Federal tax.

Racing in Florida and throughout the various States where same is legalized, is already faced with serious handicaps, such as transportation difficulties caused by rubber, gasoline, and railroad shortages, local and general dim-outs, black-outs, etc.; and Florida is particularly confronted with serious problems by reason of the fact that the Florida tracks are far removed from other turf centers of the East and the shipment to Florida tracks of horses from thoroughbred farms and from race tracks in the North thus involves many difficulties. Moreover, the tourist crop in Florida was small last winter and with the gasoline rationing, rubber shortage, and the possibility of railway seat rationing, it will be difficult for racing to survive in Florida under present conditions without the added burden of an additional 5 percent Federal tax being placed thereon.

Eighth, the Federal tax added to the present State tax would materially decrease the play and result in greatly decreased revenue to the State and tracks, and would probably destroy the racing industry.

Florida already imposes a "take," amounting to 15 percent, out of which take the State of Florida receives a tax of 3 percent from dog racing and jai-alai, and 8 percent from pari-mutuel wagering at horse tracks, and the balance of 7 percent upon horse racing and 12 percent upon dog racing goes to the operator of the activity for the purpose of:

(a) Providing an incentive for the owners of horses or dogs to take part in such activities; in other words, a purse.

(b) Providing expenses of operation, payment of income tax, etc.

(c) Providing interest or dividends on their investment, which is extremely large, and upon which dividends a very large sum is paid by the owners thereof as income taxes to the Government.

If an added tax of 5 percent is placed upon pari-mutuel wagering, the necessary result will, in the opinion of the racing commission, be to—

(a) Cause a decrease in the purses paid by the tracks to the owners of horses or dogs, which will necessarily lower the standard of racing.

(b) Decrease the profit and reduce or eliminate this source of Federal income-tax revenue.

(c) Decrease the interest or dividends on the investment, which would necessarily decrease income tax paid by individuals upon this source of revenue.

(d) Seriously cripple racing, if not completely prevent it from continuing to operate.

Ninth, the proposed tax will not produce to the Federal Government the revenue estimated. It will not produce sufficient revenue to justify the harmful effect on the State's revenue and fiscal policy.

The proposed tax, according to some authorities, will not yield more than one-third of the anticipated revenue, for the reason that by imposing the said additional 5 percent tax, pari-mutuel wagering will necessarily be materially decreased and for the further reason that we are advised that the estimated revenue is based on pari-mutuel wagering of approximately $520,000,000 and this is not indicative of the original capital involved in betting. According to expert opinion, the capital involved in wagering is not mone than one-third of said sum. If this is true, the amount derived from this tax would not be commensurate to the harm done to the financial structure of the States involved.

Respectfully submitted.

FLORIDA STATE RACING COMMISSION,
By HENRY S. BAYNARD, *Secretary*.

The CHAIRMAN. Is there another witness you wish to call, Mr. Broun?

Mr. BROUN. No, sir.

The CHAIRMAN. The committee will recess until 10 o'clock tomorrow morning.

(Whereupon, at 5:45 p. m., the committee recessed, to reconvene at 10 a. m., Friday, August 7, 1942.)

REVENUE ACT OF 1942

FRIDAY, AUGUST 7, 1942

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

The committee met at 10 a. m., pursuant to adjournment, in room 312, Senate Office Building, Senator Walter F. George (chairman) presiding.

The CHAIRMAN. The committee will please come to order.

Senator VANDENBERG. Mr. Chairman, before you call the first witness, I would like to present for the record a letter from the Detroit Edison Co., showing the physical impossibility of responding to the withholding tax section of the House bill, with particular reference to the fact that an operation of this magnitude requires accounting machines and the accounting machines simply are not available at the present time. I believe that the statement is completely persuasive. I should like to have it printed in the record and referred to the Treasury Department for consideration.

The CHAIRMAN. The reporter will include it in the record.

(The letter referred to is as follows:)

THE DETROIT EDISON CO.,
Detroit, Mich., July 30, 1942.

Mr. A. C. MARSHALL,
President and General Manager.

Re proposed new revenue act of 1942.

The House draft of the proposed new revenue act provides for certain withholdings at the source, applicable to wages, dividends, and interest. If the bill, as finally passed, should contain the same provisions, a considerable additional burden would be placed upon the company as well as upon its bond-paying agent, Bankers Trust Co., and upon all banks that cash bond-interest coupons.

Our pay-roll department would be put to a serious additional burden of expense and labor at a time when there is a labor shortage and the addition of this routine to our existing mechanical system of pay-roll preparation entails other difficulties. It might even be necessary to have additional tabulating equipment, which we understand is practically impossible to obtain.

It is difficult to describe all the various mechanical complications; but it is obvious that our paying process, which operates much like an automobile assembly line, will be slowed down considerably.

The department would have to obtain statements from each employee as to his exemption status, which involves information as to marital status and the number and age of dependents. The company would have the further burden of seeing to it that this information is kept up to date promptly by the employee.

The act provides an exemption of $11 per week for single employees and $26 per week for married employees, plus $8.50 per week for each dependent. The 5 percent withholding applies only to the balance of their weekly pay. This requires a complicated calculation to arrive at the amount of withholding.

Our present tabulating cards, which are the basis of our mechanical system, will have to be redesigned, as will the present stub of our pay orders, as the act requires that we give each employee a receipt for each deduction.

The act requires also the accumulation of data and the furnishing of returns to the Internal Revenue Bureau.

As to withholding on dividends. The work of issuing dividends probably would be doubled. We now have a very simple calculation and a mechanical process of writing checks. With a withholding, the calculations would be doubled. Our present mechanical check writers would not be adequate for the work. All checks would have to have a second stub attached (they now have a stub which we retain as our record) and be run through the machines a second time to insert the amount withheld, as the law requires that each stockholder be given a receipt for his withholding. It is doubtful if the necessary new mechanical equipment could be obtained.

Our present dividend record consists of a stub from the dividend check, which the check writer fills in simultaneously with the writing of the check. With a second stub attached to the check it might be necessary to go back to the old-fashioned hand preparation of dividend checks and the dividend record, as we do not know of any machine that would effectively prepare simultaneously a dividend check, a coupon for our record, and a stub for the stockholder's receipt. At best, some part of this record probably would have to be prepared by hand. The time we are given to get out the dividend is very limited, and hand preparation would be a serious set-back.

Here also the accumulation and forwarding of the withholdings to the Internal Revenue Bureau, together with the necessary records that we must keep, would add further work.

Many stockholders would be exempt from withholding, and the company would have to see that the proper exemptions were made and obtain certificates from such stockholders for our protection. We have stock in street form, stock held in trusts, stock held by charitable organizations, and stock held by partnerships. Some of them might be entitled to exemption; but, as a practical matter, the only way to find out probably would be to make the first withholding and wait for the stockholder to claim exemption. This would involve petty refunds and adjustments, but it is unlikely that stockholders would take the trouble to advise us in advance.

The company has a great number of small stockholders—over 8,000 holding 1 to 4 shares, and over 20,000 holding less than 25 shares. There would be a corresponding number of withholdings of a few cents each, and the work involved would be entirely out of proportion to the amount of money collected. At the present dividend rate of 30 cents per share, the 5 percent withholding on 1 share would be 2 cents (1½ cents to be exact). The withholding on 25 shares would be only 38 cents.

Our stockholders records department would have to prepare lengthy detailed returns for transmittal to the Internal Revenue Department periodically.

Also although not directly our problem, we might refer to the work that will be placed upon the banks and upon our bond paying agent. Every interest coupon paid by a bank would call for a withholding (unless exempt) and would require a record thereof as well as a receipt to the bondholder. The banks would be obliged to obtain certificates from bondholders claiming exemption. They also would be required to compile and forward detailed reports to the Internal Revenue Bureau. Here again, many of the withholdings would be very small.

Yours very truly,

(Signed) A. D. SPENCER,
Treasurer.

The CHAIRMAN. We have a carry-over of a few witnesses of yesterday who kindly gave way for the pari-mutuel people, and we will call them first this morning, unless there is some special reason why some of the other witnesses have to leave early.

Mr. Glassgold.

STATEMENT OF GEORGE M. GLASSGOLD, NEW YORK, N. Y., REPRESENTING COIN MACHINE MANUFACTURERS

The CHAIRMAN. Mr. Glassgold, three of you gentlemen here on vending machines. Are you speaking on different types of machines, or are you speaking on the same subject?

Mr. GLASSGOLD. I really do not know, Senator. I am here just on one feature of the section. It is very short.

The CHAIRMAN. You may proceed.

Mr. GLASSGOLD. Mr. Chairman, and gentlemen of the Finance Committee. I appear before you with regard to the proposed section 617 relating to coin-operated amusement and gaming devices. This section amends certain features of section 3267 of the existing Internal Revenue Code.

I believe that the present existing code has not operated practically nor equitably and for this reason has not returned the potential revenue to the Government as contemplated. These results are due to several factors. As the present tax provision now exists and even as amended to section 617, coin-operated devices are classified according to usage instead of the more simpler and fairer method of being classified according to their physical characteristics.

Taxing by usage creates both loopholes and a policing problem for the Internal Revenue Bureau. Such a method also puts a premium on tax evasion, whereas, taxing on the physical characteristics of each machine is direct, definite and leaves no room for differences of opinion as to tax classification. Furthermore, the income capacity of coin-operated machines varies greatly, so that under the existing tax laws many types of amusement equipment have been legislated out of existence and revenue has been lost.

I, therefore, request that the amendment of the proposed section 617 be given consideration with a view to keeping the maximum number of coin-operated machines in operation. By that method substantial investments in machines will not be lost and at the same time a greater revenue will be realized for the Government.

I respectfully submit that the following classifications should be made in coin-operated equipment to achieve these ends:

1. Any machine which operates by the insertion of a coin, token, or similar object and which automatically pays out cash, tokens, or similar objects of value and requires for the operation of the machine the use of a coin, taken, or object of similar value of 5 cents or more, shall be taxed at $50 per annum.

2. Any machine which operates by means of the insertion of a coin, token, or similar object and which automatically pays out cash, tokens, or similar objects of value and requires for the operation of the machine, the use of a coin, token, or similar object of the value of less than 5 cents, shall be taxed at $10 per annum.

3. Any machine which operates by means of the insertion of a coin, token, or similar object and which cannot automatically pay out a coin, token, or similar object of value but which may be equipped with a mechanism for the continuation of further play of the game without the insertion of an additional coin, token, or similar object as the result of a score obtained by the player of such game, and which operates by the use of a coin, token, or similar object of the value of 5 cents, shall be taxed at $10 per annum.

4. Any machine which operates by means of the insertion of a coin, token, or similar object and which cannot automatically pay out a coin, token, or similar object of value but which may be equipped with a mechanism for the continuation of further play of the game without the insertion of an additional coin, token, or similar object

as the result of a score obtained by the player of such game, and which operates by the use of a coin, token, or similar object of the value of less than 5 cents, shall be taxed at $5 per annum.

5. Where machines each having a tax classification of $10 per annum or less are assembled for use in one location—so-called arcades or similar amusement centers—and 10 or more of such machines are assembled in any one such location, the aggregate tax to be paid on such location shall not exceed $100 per annum.

6. The taxes to be paid in accordance with the foregoing provisions shall be payable in semiannual installments.

The classifications set forth above take into consideration all of the various types of machines now being used and classify them according to their earning capacity. It likewise contemplates the differences existing in the laws of the various States. Specifically, I refer to the so-called free-play units in many of the amusement devices, whereby a player is permitted to continue to play on the game provided he reaches a certain indicated score. Among these devices are the electric shooting gun, the hockey game, or similar machines. The free-play device is permissible in some States, whereas by statute in other States it is prohibited as a gaming device. The taxing provisions as they now stand attempt to make a distinction between games of chance and games of pure amusement, but makes no distinction as to the degree of chance which in turn affects the ability of the machine to pay the tax imposed.

The $50 tax classification contemplates the so-called slot machines which are games of pure chance and having a higher income. On the other hand, there are many amusement machines such as the electric eye shooting game, and so forth, which require the skill of the person playing the game, and where the element of chance is inserted into the make-up of the game for the purpose of creating interest. We are fully aware of the fact that no matter how skillful a game may be, even our national game of baseball, there is always the element of chance that enters into the play. It is the element of chance which has the appeal for the public, but the nature of the element of chance will determine the earning capacity of the machine.

Lastly, I refer to the last portion of the proposed amendment which reads as follows:

> For the purposes of this section, a vending machine operated by means of the insertion of a 1-cent coin, which, when it dispenses a prize, never dispenses a prize of a retail value of more than 5 cents, shall be classified under clause 1.

That is the amusement clause.

I believe that this provision was intended to give relief to the so-called merchandise stimulators which readily disappear from the market if severely taxed. However, the relief intended is not effected by the proposed amendment, since these merchandise stimulators cannot be classified as vending machines because many of these machines do not dispense any prize, token, or merchandise automatically. It is in the score on the machine or other some such similar device which determines the prize or premium to be obtained. Furthermore, these merchandise stimulators usually give as a prize a package of cigarettes or some such merchandise of equivalent value, which, of course, exceeds 5 cents in value.

As to these machines, we therefore urge our definition in place of the language used in the present proposed amendment if these machines are not to disappear from the counters and the revenue lost to the Government.

Thank you, gentlemen.

The CHAIRMAN. Thank you, sir.

Mr. Lansing.

STATEMENT OF HAROLD S. LANSING, CHICAGO, ILL., REPRESENTING THE NATIONAL VENDING MACHINE ASSOCIATION

Mr. LANSING. Mr. Chairman and members of this honorable committee, my name is Harold S. Lansing, of Chicago, Ill., and I am appearing in behalf of the National Vending Machine Association.

May I state at the outset that the problem which I have to present before the committee this morning is separate and distinct from that which was presented by the honorable gentleman who has just preceded me.

May I call the committee's attention to the fact that the only machine that was recognized by the Ways and Means Committee as in need of special relief from the provisions of the Revenue Act of 1941 is the machine which appears on this table before the committee this morning.

The CHAIRMAN. Did they give you relief?

Mr. LANSING. Well, Mr. Chairman, the relief which they attempted to give us, in good faith, through some apparent error or misunderstanding, certainly put us just as much out of business as would the statute before amendment, and that is the problem which I wish to submit to the committee this morning.

May I refer to page 314 of the House bill, the provision to amend the act, for the convenience of the members of the committee.

This machine is a merchandise vending machine which dispenses ball gum.

By the insertion of a penny, the customer is entitled to a candy-coated ball of chewing gum.

If the customer receives a particular colored ball, in this instance, a yellow ball with the red stripe, he is entitled to an additional 5-cent bar of candy.

The reason for bringing this machine here this morning, as I presented it to the Ways and Means Committee, was to demonstrate conclusively that there are no reels, gadgets, or devices of any kind or particular combinations for gambling.

This is a purely merchandise vending machine.

Now, the casualty which occurred to us, gentlemen, was this: When the Congress originally framed section 3267 of the 1941 Revenue Act they levied a tax of $10 against amusement devices, $10 per year and a tax of $50 per year against so-called slot machines, and in defining the so-called slot machines the verbiage was made very broad and comprehensive.

Briefly, they define slot machines as any machine operated by a coin which, by application of the element of chance, would entitle the customer to some chance award. It stated that it did not include

bona fide vending machines of merchandise provided there would not be any gaming features incorporated in the machine.

Now this machine, gentlemen, which was demonstrated before the Ways and Means Committee, is in a class of very limited income. It cannot even compare with the machines which the gentleman who preceded me discussed. Before the Ways and Means Committee, it was demonstrated that by survey the average gross revenue per year from this penny machine was about $30, and that the profit amounts to approximately $8 of which the shopkeeper receives $4, and the distributor and servicer of the machine receives $4.

That was discussed freely before the Ways and Means Committee and several Congressmen, in discourses with me, came to the conclusion that it was impossible for this machine to pay a $50 tax, or anything like a $50 yearly tax.

Now, if I may impose upon the patience of the committee, I shall try to be very brief. Immediately after the enactment of the 1941 act, with this definition of a so-called slot machine, confusion arose in the minds of deputy collectors in the Bureau of Internal Revenue, as it would seem that by this broad and foolproof language, which was originally designed to eliminate any evasion on the part of the so-called slot machine operators, it would seem that by a strict construction of that language our machine might be included, but to the casual observer, it would also appear that this is only a merchandise vending machine and its income is so limited that it was never intended that it be taxed, I believe, in any amount.

Therefore, 9 days after the enactment of the statute, we obtained a written opinion from the Bureau of Internal Revenue, of which I have photostatic copies, signed by the deputy in charge of the Miscellaneous Tax Division, in which he stated, in writing, that this particular type of machine was not included within the purview of section 3267.

Our operators continued in business for about 5 months, until on March 16, 1942, the Legal Department, in reviewing the situation, reversed the opinion of Mr. Bliss and stated by a strict construction of the wording of the statute this must be considered as a gaming device, and therefore the $50 tax became operative and naturally our business was at an end.

Shortly thereafter, we were granted a hearing before the Ways and Means Committee, to be exact, on April 13, and our problem was demonstrated to them. They seemed to be in accord with us, and we suggested an amendment, the exact wording of which has been adopted in the recommendation of the Ways and Means Committee, and which is now incorporated in the proposed amendment, but through some unfortunate misunderstanding, which I am at the present time unable to comprehend, they classified our machine in class I of section 3267, namely, an amusement device subject a yearly tax of $10.

Now this machine is hardly an amusement device. It has been removed from the classification of a gaming device by the amendment.

Why the $10 tax was imposed, I am unable to comprehend, but I do say this to you gentlemen here this morning that that $10 tax puts us out of business just as effectively as the $50 tax.

With an $8 yearly net profit, naturally we cannot pay a $10 tax.

We are not seeking any special favor; we are merely asking that we be given the right to exist and to remain in business.

Senator TAFT. Why do you have to have a 5-cent prize?

Mr. LANSING. The answer to that, Senator Taft, is this—and I have it in my prepared statement—whereas the manufacturers of trade-marked gum expend tremendous sums to advertise their product, the gum-ball manufacturers cannot compete with that advertising.

In order to sell their product, they have formulated this merchandising method of giving the bar of candy with the yellow-striped ball.

Senator TAFT. Does the storekeeper hand it out?

Mr. LANSING. That is right. The distributor who distributes this machine furnishes, I believe, two boxes of candy bars with each fill of ball gum, and the customer always receives a 1-cent ball of gum, but upon receipt of the yellow ball he gets a 5-cent bar of candy, and the shopkeeper hands out the bar of candy, honors it for the yellow ball.

Now, may I demonstrate to the committee that our machine was the only one that was singled out for relief in this case? My prepared statement refers to the Ways and Means Committee report, which points out that the amendment was designed to relieve the so-called 1-cent ball-gum machine.

Now, why the $10 tax was imposed I do not know, unless this may have happened: I may have been confused with representatives of some of the other counter games who, I understand, appeared before the Ways and Means Committee about 5 days before I appeared, and these counter games include the so-called cigarette prize machines. The various reels which, according to the combination, you are either entitled to a package of cigarettes or not. They offered to pay a $10 tax per year and, of course, can very well do so because of the tremendous difference in their income.

Now, there may have been confusion between our type of machine and theirs, and the other operators offered to pay $10 per year. But I say to the committee if this $10 tax is permitted to remain on our particular machine, we cannot exist.

The CHAIRMAN. What tax do you suggest? None?

Mr. LANSING. Well, Senator George, in my prepared statement I state that it is my belief, and the belief of our operators, that it was never intended to tax our machine. We were just a casualty of construing legislation, but if it will assist the war effort, we believe that, by making sacrifices, we can pay approximately $3 per year on an $8 profit.

There being approximately 300,000 of these machines in circulation, it is our estimate that the revenue that could be brought in on such a collectible tax would be approximately $1,000,000.

If the committee is of a mind that we should pay a tax, that is the amount under which, I believe, we could remain in business, but we certainly cannot pay a $10 tax. If that is to be imposed, we must retire from business. The people who operate these machines are family men throughout the country, shopkeepers, and distributors who pay taxes in the normal course of affairs, and I plead for relief of these particular people.

The CHAIRMAN. Are there any other machines that dispense articles of 1-cent value, with a possible gain of five additional pieces, or a 5-cent article?

Mr. LANSING. There are these other counter games which accept 1-cent coins, Senator George, but they do not fall within this classifi-

cation, the most common of which is the cigarette machine which contains the three reels, the spinning reels, just like the slot machine does, and if you get a certain combination you get cigarettes. As I understand, if you do not win you get nothing. This [indicating] is primarily a merchandise-dispensing machine.

The CHAIRMAN. Do the other merchandise-dispensing machines deal in substantially the same figures?

Mr. LANSING. I know of none that are comparable, Senator.

The CHAIRMAN. The point is, how could we distinguish your machine from theirs?

Mr. LANSING. We could very well. As a matter of fact, the Ways and Means Committee has already distinguished our machine, but what they did was to place us in class I as an amusement device and tax us $10. They have distinguished our machine. Do I understand the Senator to mean that there may be other machines in the same classification which give out the same type of merchandise?

The CHAIRMAN. Yes; that have very low yields, too.

Mr. LANSING. That is quite possible. Well, would not the wording of the amendment protect them also? Is it not, after all the question of the ability of the taxpayer to pay?

The CHAIRMAN. Well, some of them might have very high yields.

Mr. LANSING. A very high yield?

The CHAIRMAN. Yes; some types of machines.

Mr. LANSING. Well, if there are such machines, I am unaware of it, and I have studied this case for almost a year now.

I believe we have the only machine in this particular class, Senator.

The CHAIRMAN. I am making the inquiry because of the difficulty of distinguishing your machine, possibly, from others.

Mr. LANSING. Of course, there is this to say, Senator, that any machine which accepts a 1-cent token and entitles the customer to additional merchandise, not in excess of 5 cents is necessarily confined to a very limited amount of income.

Senator TAFT. What I wondered about was whether there is any other kind of machine that takes somewhat more money in, that the Ways and Means Committee intended to reduce from $50 to $10. In other words, could there be another intermediate class of machine, another amendment reducing some kind of machines like those that dispense cigarettes, which is more than the 5 cents?

They moved this from $50 to $10 and I wonder if they had in mind some other machines that yours that could pay $10.

Mr. LANSING. May I demonstrate conclusively, I believe, to yourself, Senator Taft, what they did have in mind by reading briefly from the report of the Ways and Means Committee with reference to this amendment.

Under the present law, and I quote:

> Certain types of vending machines which are now subject to the $50 tax rate as "gaming devices" are to be taxed as amusement machines. Such machines under the bill will be considered, for the purpose of the tax, as amusement machines, subject to the rate of $10. * * *
>
> This amendment covers vending machines operated by the insertion of a 1-cent coin and which occasionally dispense prize objects, entitling the player to receive

a prize of a retail value not greater than 5 cents, such as the well-known 1-cent "ball gum" machines which dispense prize balls generally entitling the player to a 5-cent bar of candy or some similar prize.

Therefore, it is apparent that this is the only machine that the Ways and Means Committee had in mind. But, according to our earnings, which appear of record in the proceedings before the Ways and Means Committee, it is physically impossible to pay a $10 tax, and therefore we must have some relief.

The CHAIRMAN. Well, we have your point.

Senator CONNALLY. May I ask the witness a question?

The CHAIRMAN. Yes.

Senator CONNALLY. Your machine operates on a 1-cent basis?

Mr. LANSING. Yes.

Senator CONNALLY. A copper?

Mr. LANSING. Yes.

Senator CONNALLY. You may get a prize or you may not, is that right?

Mr. LANSING. That is correct.

Senator CONNALLY. Why is not that a gambling machine?

Mr. LANSING. Beg pardon?

Senator CONNALLY. Why is not it a gambling machine?

Mr. LANSING. Well, it is not a gambling machine.

Senator CONNALLY. Gambling with coppers instead of, like the big shots at the race track, with a $2 bill?

Mr. LANSING. I disagree with you, Senator.

Senator CONNALLY. I am asking you a question. I am not testifying.

Mr. LANSING. I shall attempt to answer it to the best of my ability.

This machine dispenses merchandise. For each 1-cent inserted you get a 1-cent ball of gum.

If you get a yellow-colored ball with the red stripe, you get a 5-cent bar of candy in addition.

Senator CONNALLY. You would lose money then. If you give out prizes at all, you are just out the prizes.

Mr. LANSING. If we were losing money, I do not believe we would be here today, Senator. We are barely making a living on this machine. The additional candy bar is simply a sales stimulator. There is no gambling device or gadget incorporated in this machine.

Senator CONNALLY. Thank you.

The CHAIRMAN. All right; we have your point.

Thank you very much.

Mr. LANSING. May I ask leave to introduce my short written statement for the record, Mr. Chairman?

The CHAIRMAN. Yes, you may.

Senator CONNALLY. Is your machine working now?

Mr. LANSING. Yes, sir.

Senator CONNALLY. Let me try it.

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

BRIEF OF HAROLD S. LANSING, OF BLANKSTEN & LANSING, CHICAGO, ILL., COUNSEL FOR NATIONAL VENDING MACHINE ASSOCIATION

HONORABLE SIRS: The only amendment to section 3267 of the Revenue Act of 1941, as recommended by the House Ways and Means Committee, is with regard to our particular type of machine, and an examination of the proposed amend-

ment demonstrates at once that it was never intended that our machine be classed as a gaming device within the statutory definition thereof requiring a $50 yearly tax. It is apparent, as we argued before the Ways and Means Committee, that the inclusion of our machine in the $50-tax classification was a casualty resulting from unfortunately broad statutory wording. We believe it can safely be said that it was never intended to levy a tax in any amount against our particular type of machine, and this was the original opinion of authoritative individuals in the Department of Internal Revenue.

The vending machine in question, which is distributed and serviced by members of this association, is of simple design, containing a glass bowl filled with candy-coated ball gum of various colors. The customer inserts a penny in a slot, turns a lever, and receives a ball of chewing gum. Receipt of a ball of a certain particular color (commonly a yellow ball with a red stripe) entitles the customer to receive a small 5-cent candy bar from the shopkeeper. Nothing is inscribed on the machine, nor is there any attachment incorporated indicating that the person using the machine may be entitled to receive a chance award. This is a bona fide merchandise-vending machine containing no gambling reels, spinners, devices, or gadgets of any kind, and is not a slot machine as defined by the statute. The additional candy bar is a merchandising method which assists the ball-gum vendors in selling the ball gum. Whereas the manufacturers of trade-marked gum expend tremendous sums for advertising in order to stimulate sales, the sellers of ball gum, being unable to compete with such advertising, engage in this merchandising method to promote and stimulate normal sales.

In defining so-called slot machines for the purpose of levying a $50 yearly tax, the legislature formulated foolproof wording in order to eliminate evasion by the well-known slot-machine operators. However, by this wording a strict and unrealistic construction would seem to place our machine in the same category as the so-called slot machine, requiring payment of a $50 tax. That our machine was never intended to be taxed was originally demonstrated by a written opinion rendered by D. S. Bliss, Deputy Commissioner of the Treasury Department, on October 9, 1941, shortly after the enactment of the statute. This opinion flatly exempted our type of machine from the tax imposed on coin-operated amusement and gaming devices. However, on March 18, 1942, the Bureau of Internal Revenue reversed its position because, as we understand it, its Legal Department felt that a strict construction of the terminology of the statute swept this machine into its terms.

On April 13, 1942, we appeared before the House Ways and Means Committee, displayed our machine, and apprised the committee of the fact that the average gross yearly intake is approximately $30 per machine; that the gross profit amounts to approximately $8 per machine, and the net profit about $4 to the storekeeper, and $4 to the distributor. (Revenue revision of 1942, hearings before the Committee on Ways and Means, House of Representatives, vol. 3, p. 2682 et seq.) Reference to the discussion between our representative and certain Congressmen of the committee, with respect to this situation, will disclose the reasons why the committee concluded that our machine is not of a type to be regarded as being subject to a tax under section 3267 of the Revenue Act of 1941. The Ways and Means Committee has, to our deep gratification, recognized our problem, and has singled out our machine as being entitled to special relief, but, unfortunately, and apparently in the rush of more pressing and urgent matters, has placed us in the category of amusement devices subject to a yearly tax of $10, which is fully as confiscatory for all practical purposes as the $50 tax.

We wish particularly to call the attention of your honorable committee to the fact that the Ways and Means Committee, by its proposed amendment, has definitely removed our machine from the category of gaming devices. This, in itself, recognizes the incontrovertible fact that the giving of a 5-cent candy bar with a particularly colored ball of gum is strictly a small-scale merchandising method. By the same token, it is nothing less than an anomaly to classify our machine as an amusement device since the customer, who is not called upon to exercise any degree of skill, is, in the first and last instance, purchasing merchandise. It, therefore, becomes obvious that the Ways and Means Committee definitely intended to afford relief to our operators and storekeepers, but did not accomplish the result which it apparently felt we were entitled to. Ours is definitely not an amusement device, and, since it is not a gaming device, it does not fall within either classification provided in section 3267, and because of the fact that both the $50 tax and the $10 tax would be confiscatory, our class of machine should be wholly exempt from the provisions of section 3267.

As stated before, our business is at an end upon the basis of a $10 tax, as well as a $50 tax, for the earnings and profit speak for themselves. The distributors of these machines are small businessmen who contribute their share of the tax burden of this country through the usual existing channels. By curtailing their net profit, as well as that of the shopkeeper, it is conceivable that they might afford to pay a yearly tax of $3 as a maximum. Based upon an approximate total of 300,000 machines now in operation throughout the country, this would bring a tax revenue of nearly $1,000,000 yearly. A tax higher than this figure would simply be uncollectible. While it is our firm conviction that it was never intended, at least for the time being, to obtain tax revenue from this type of machine, nevertheless, decision as to whether or not a $3 tax should be levied, or outright exemption granted, is submitted to the discretion of this honorable committee. Certainly the distributors and storekeepers are definitely in need of relief from the $10 amendatory tax now recommended by the House Ways and Means Committee.

Before the House Ways and Means Committee, we proposed an amendment, part of the wording of which was adopted by the committee in reclassifying us an amusement device. We again urge this committee to give consideration to our proposed amendment of clause (2) of subsection (b) of section 3267 of the Revenue Act of 1941, to read as follows:

"(2) So-called slot machines which operate by means of insertion of a coin, token, or similar object and which, by application of the element of chance, may deliver, or entitle the person playing or operating the machine to receive, cash, premiums, merchandise, or tokens. The term does not include bona fide vending machines in which are not incorporated gaming or amusement features, nor does it include vending machines dispensing merchandise exclusively, some of which merchandise, by virtue of its color, shape, or character, would entitle the person operating the machine to receive additional merchandise: *Provided, however,* That said type of machine is limited to operation by 1-cent coins and the additional merchandise given to the person operating the machine shall not exceed in retail value the sum of 5 cents for each insertion of the coin: *And provided further,* That said vending machine is not incorporated in or operated in conjunction with any slot machine."

Respectfully submitted.

NATIONAL VENDING MACHINE ASSOCIATION.

The CHAIRMAN. Mr. Bruntjen.

STATEMENT OF HERMAN A. BRUNTJEN, REPRESENTING MIDLAND OPERATING CO., MINNEAPOLIS, MINN.

The CHAIRMAN. You are appearing here on this same subject, Mr. Bruntjen?

Mr. BRUNTJEN. Yes. May I proceed?

The CHAIRMAN. Yes.

Mr. BRUNTJEN. Mr. Chairman, I am the president of a small corporation from Minnesota and my name is Herman A. Bruntjen. This corporation operates 1,500 of the type of machines described by Mr. Lansing. For all practical purposes, it is the same machine, except our machine might be a little larger and the volume might be a little greater.

This proposed tax of $10 is too much on this type of machine, for the simple reason that the earnings of these machines simply do not justify the expenditure of that $10 tax.

I have a profit and loss statement from the operation of these 1,500 machines mentioned before, and it shows a very small profit per machine after allowing for depreciation of these machines on a 10-year basis.

Our machines, by the way, cost $10 and after allowing this depreciation of $1 per year the machines show a net profit on a year's operation of each machine of 19.7 cents per month, or $2.36 per machine

per year, which makes a net profit of $3,668.84 per year on these 1,500 machines.

Senator TAFT. How much per month?

Mr. BRUNTJEN. Nineteen and seven-tenths cents.

Senator TAFT. Cents?

Mr. BRUNTJEN. Yes. Now, these 1,500 machines represent an investment of $31,150, including the cost of placing the original merchandise in the machines and various other expenses.

If we were to pay a tax of $10 per machine per year this would mean we would have to pay $15,000 taxes, against a net income of $3,568.84.

I would like to make this observation in addition, that these machines are placed in small combination confectionery stores and small grocery stores and these stores have a hard time existing as their prices have gone up without their having the ability to charge more, because the candy bar is still 5 cents, and the ice-cream cone is still 5 cents.

Senator VANDENBERG. On the basis of your statement, you could not pay a $3 tax?

Mr. BRUNTJEN. Correct, I disagree with Mr. Lansing on that. We could not even pay the $3 per machine per year.

However, I grant this: An individual might be able to operate these machines more profitably than a corporation could. A corporation is naturally more subject to expenses than an individual would be, but even a $3 tax would put us completely out of business.

These machines serve as trade stimulators in the stores. The most a person can get is 5 cents' worth of merchandise, retail value, costing the merchant about 3 cents.

The way we operate our machines is as follows: If the person gets the so-called striped gum ball, he would have a choice of either an ice-cream cone, pop, or candy bar. It is up to them, whatever they want.

The stores are interested in selling, of course, such an item as ice cream because it is a good profit item to them.

We have had no complaints from anybody on these machines in any way that these machines constitute gambling or corrupt the morals of anybody.

Senator CONNALLY. Does your machine give a prize that is capable of being rigged?

Mr. BRUNTJEN. No. We place 1,000 gum balls in this machine, and to every 1,000 gum balls, we put 100 yellow-striped balls in the machine, on which the prize is given, making a total of 1,100 gum balls in the machine. That proportion always remains the same.

When the machines are checked, we pay the merchant $5 for these 100 yellow-striped gum balls from the machine. In other words, the merchant has sold $5 worth of merchandise, which might be candy bars, ice cream, or soft drinks. In addition to that, we give the merchant 10 percent of the balance.

That leaves us nominally $5.40 every time the machine empties, out of which we pay the cost of collections, general overhead, the cost of the merchandise, and the cost of installation of the machine.

Now, we do business with 1,500 of these small storekeepers in Minnesota and Wisconsin, and the storekeepers really appreciate the few cents that they make on these machines. They do not make much, but it is something that gives some of them an opportunity to compete with the larger stores.

These are the smaller stores where the machines are placed. The chain stores and large drug stores are not interested in these machines, for the simple reason that it takes too much time, too much effort to bother with them.

However, the small storekeeper will take the time, because he likes to have a little more money to pay his telephone bill or light bill.

Now, I have letters, which I shall not take the time to submit, from the small storekeepers that were written to us, in which they express their desire of keeping these machines in operation in their place of business and their appreciation for the help they received from these machines.

The CHAIRMAN. Well, sir, we thank you for your presentation.

Mr. BRUNTJEN. Thank you.

The CHAIRMAN. Mr. Daubin.

STATEMENT OF MEREDITH M. DAUBIN, WASHINGTON, D. C., REPRESENTING AUTOMOTIVE PARTS REBUILDERS' ASSOCIATION

The CHAIRMAN. Mr. Daubin, we have three witnesses here on parts and accessories. Are they all speaking to the same point?

Mr. DAUBIN. No, they are not, Mr. Chairman; they are covering different phases of the industry.

The CHAIRMAN. You may proceed.

Mr. DAUBIN. Mr. Chairman, and gentlemen of the committee: My name is Meredith M. Daubin. I am an attorney in the Munsey Building, Washington. I appear as attorney for the Automotive Parts Rebuilders' Association, consisting of auto parts repairmen covering the entire United States.

The Bureau of Internal Revenue has held that the repairing or rebuilding of used automobile parts is the manufacturing or producing of an auto accessories and that the sale thereof is taxable under section 3403 (c), Internal Revenue Code, which at present rate is 5 percent.

The Automotive Parts Rebuilders' Association is a national nonprofit organization formed last year by auto parts repairmen in order to bring before this committee the exact situation involved. There are present today three members of the association, all repairmen of auto parts known throughout the trade as rebuilders. Their method of business is typical of that of all the auto parts rebuilders throughout the United States. To have brought more members here today to testify would have been merely repititious and cumulative.

This application of the excise tax emanates from the Bureau of Internal Revenue in construing that repairing and rebuilding of used parts is "manufacturing" under the statute and that the sale is taxable.

We do not believe it was the intention of Congress to tax the mere repairing or rebuilding of auto parts and that Congress had in mind the sale of only the newly manufactured auto part.

The situation today as between the Bureau, the collectors, and the repairmen is in complete confusion throughout the entire country.

First: The Bureau of Internal Revenue, though repeatedly requested, has failed to issue a public ruling on just that (*a*) auto accessories or parts are to be taxed; (*b*) the distinction, if any, be-

tween a repairing of one unit as against the handling of two or more at the same operation; (*c*) the distinction, if any, where the same parts plus new parts are reassembled in the original unit as against the comingling of parts from different units when reassembling after cleaning and repairing; and finally, (*d*) whether the excise tax is to be calculated on the net sale price of the repaired part or on the price plus exchange credit for old part returned. The Bureau also refuses to allow any credit for the tax paid on the old part at the time of its previous sale.

The Bureau will answer only questions presented by each specific case of each taxpayer and limits the ruling to the taxpayer involved. The result is that there is a complete lack of uniformity amongst the collection districts; and each individual internal-revenue collector or agent can make his own decision as to who is a manufacturer, what items shall be taxed, and how the tax shall be calculated.

Therefore, we request this committee to—

1. Take a forthright stand and amend the law by stating—

parts or accessories *including repaired, overhauled, or rebuilt parts or accessories* (other than tires and inner tubes and other than radios), for any of the articles enumerated * * *. (Amendment printed in italics.)

Then excise revenue can be collected uniformly from coast to coast, as this will now make parts repaired subject to the excise tax as it will be then in the law.

2. The rebuilt unit is sold upon an exchange basis—the exchange unit has borne its tax when sold new—therefore the tax should be calculated upon only the amount received by the repairman for his charge for the repair or rebuilding of the unit.

The exchange unit is merely his nest egg, through which he operates his repair business. Therefore, we request this committee to adopt the afore-mentioned amendment plus the following addition:

The tax shall not be calculated on the unit exchanged but only on the net sale price on repaired, overhauled, or rebuilt parts or accessories.

The different revenue districts are applying the calculation of this tax in many different ways. Some on the entire listed price, including the exchanged unit; others on the net amount received for the labor and materials; others scale down the value of the exchanged unit by an arbitrary percentage, and still others claim no tax whatsoever is due on rebuilt, repaired, or exchanged units.

I have here a file of letters from customers of members of our association in which the customers refuse to pay the excise tax at 5 percent on the full list price of the repaired part, claiming that they can buy the same part with the tax calculated on only the sales price of labor and materials with no tax on the old unit they send in for exchange. Other letters claim an overcharge because the tax is calculated on the exchanged unit or because no credit is allowed on the old unit on the basis that it is a previously taxed article.

It is impossible for the repairmen to absorb the tax as calculated by the Bureau, because in many instances the tax is 30 percent of the actual price received by the repairmen. For example, on Ford V-8 distributors (1937 model or later) the rebuilder in repairing the article actually receives $1.10 with a $5 deposit charge which is credited to

the customer when the old unit is turned in; which in most instances is either before or simultaneous with the sale of the repaired or rebuilt part.

The Bureau taxes at 5 percent on the basis of $6.10 resulting in a tax of 30½ cents. A new Ford distributor unit recently sold for $4.50 with a tax of 22 cents, yet the "repair" change carries the unheard-of tax of 30½ cents on the actual value of $1.10, or almost 30 percent tax.

3. Finally, and in lieu of the two above-suggested amendments, we ask that the present law be amended to eliminate any question as to the propriety of holding the repairmen or rebuilder a manufacturer under the above instances, and to specifically delete repaired and rebuilt automobile parts from being considered as taxable under the present law by the adoption of the following amendment [printed in italics] to section 3403 (c) to read as follows:

Parts or accessories, *other than repaired, reconditioned or rebuilt parts or units when sold as such.*

This would definitely eliminate repaired and reconditioned auto parts from the tax.

Why should a repairman be called a manufacturer?

The Bureau does not attempt to tax the sale of a second-hand automobile, even though a second-hand auto is repaired, reconditioned, and then sold.

Why should the repairing and reconditioning of a temporary and partly unusable second-hand auto part be called manufacturing and the repairmen be made to pay an excise tax on the sale of the services rendered? In many instances the unit is repaired 10 times or more during its lifetime, yet the full tax was collected when it was sold either as a new unit or as the working part of an automobile and the Bureau now proposes to tax this part each time it is repaired or rebuilt.

Automotive Parts Rebuilders Association urges amendment of section 3403 (c) Internal Revenue Code, as amended by section 544 (a) of the Revenue Act of 1941, which places a tax on manufacturers of automotive parts and accessories.

The interpretation by the Internal Revenue Bureau has been confusing; the administration by the Bureau has been conflicting in different localities, even though the Senate Finance Committee reported "repaired and reconditioned parts are not now subject to tax" the Bureau has placed a tax on "repaired" and "reconditioned" automotive units, previously taxed when they were originally installed on a car.

Automotive parts rebuilders are repairers and not manufacturers.

To manufacture is to create, make, or produce an article—a new article—but to recondition a used unit which has been in service is not manufacturing.

A few years ago, if a generator, brake, or other unit of an auto did not function properly a garageman removed the unit from the car, repaired it and replaced the same unit in the car.

This process required considerable time, preventing the use of the car while the repair was made. Some repairmen became specialists. Because of inexperience of garage mechanics and to save time, the custom now is to remove the damaged unit and immediately substitute a unit previously repaired, making possible continuous operation of

the car. The repair specialist is called a rebuilder. He does not create a new unit, but reconditions one which has been taxed originally—and because the Internal Revenue Bureau taxes the rebuilders sales, the unit has been taxed as often as it has been exchanged, often several times.

The Internal Revenue Bureau concedes that working on one unit at a time is "repair, not taxable," but if for efficiency the rebuilder dismantles and cleans several units at a time, the Bureau classes the work as "manufacture, taxable"—the results are the same.

The average cost of repairing only is the usual charge, but if the old unit is not received at the time of the transaction, a deposit charge is made pending the return of the old unit. The Internal Revenue Bureau assesses the rebuilder on all exchange transactions on the total charge of the repair cost plus the deposit charge of an old unit (often more than the total cost of a new unit) resulting in a tax of as much as from 10 to 30 percent of the net sale by the builder. The Bureau says:

> The tax is based upon the exchange charge plus the core deposit of any unit exchanged. If because an old unit is turned in at the time of exchange the taxpayer's billing shows only the exchange charge, the Internal Revenue Bureau will add an amount equal to the core deposit that would have been made if the old unit was not returned.

Units like generators, distributors, or fuel pumps are complete units, repairable by garagemen by replacing one or more parts. There is no tax on complete automobiles, reconditioned or rebuilt, and there should be no tax on complete units, conditioned or rebuilt.

In the manufacturing business each sale is a final and complete sale. In the "exchange" business the commodity involved is repair work, as the transactions include the return of a similar article capable of being repaired, which the "exchange" unit replaces. The repaired unit is labeled "reconditioned" or "rebuilt" and is never sold for original equipment. Any deposit charge made, pending the return of the old unit, is credited to the customer on receipt of the old unit. This deposit is a fictitious value, or excessive charge, to insure the prompt return of the old unit, because this is a repair business and the rebuilder must have an old unit to work on. Rebuilders do no casting, manufacturing, or creating of units out of raw material, but only work on used units which were original equipment on a car, so the rebuilder is actually repairing tax-paid units.

If it is the intent of Congress to place a tax on such repair work, then the act should so state, and make it plain that "repairs" are subject to tax, whether done by an individual garageman or a wholesale repairer or rebuilder—but if the intent is not to tax repairs, the Automotive Parts Rebuilders Association respectfully urges the addition of the following words: "Other than repaired, reconditioned, or rebuilt parts or units when sold as such," or such other wording as may seem appropriate.

Senator TAFT. What is the rule? If an automobile is repaired by inserting a new part, I suppose there is a tax on that new part?

Mr. DAUBIN. There is a tax on that new part.

Senator TAFT. But not on the labor of the repairing?

Mr. DAUBIN. Not on the labor of repairing of the second-hand automobile, but on the new automobile there is a tax, as we know. Yet, if

you repair a second-hand automobile, that is not considered manufacturing, unless a new part is purchased.

Let me point this out. Our repairmen buy a new distributor part, and they pay a tax on that. Then they combine their labor in the temporarily unused part and repair it so it will function, but the Bureau says there must be a tax paid because they manufactured something, when they merely repaired the article to make it usable.

The CHAIRMAN. You had the matter up last year?

Mr. DAUBIN. Yes; we had the matter up last year. It came before this committee last year. At that time you were not considering administrative amendments. You had here the members of the association, and after that time my recollection is, it was stated by the committee that there was not now any tax in the law on these parts, but they would leave it up to the Bureau to make such arrangements as were necessary to eliminate the tax on repaired parts.

The CHAIRMAN. I thought the Bureau was to take care of it.

Senator HERRING. Mr. Chairman, that was the understanding. The evidence was clear. The statements made to the collector were clear.

Senator LA FOLLETTE. It is my recollection that the committee virtually went on record in favor of something being done, went on record for relief being given by regulation.

Mr. DAUBIN. In answer to your statement, gentlemen, I will read——

The CHAIRMAN. I have reference to the conference, which, of course, is not reported. The matter was in conference, and my recollection is that definitely, the Bureau was to take care of it, was to have a unifrom ruling, not for one district alone, was to impose a tax that was uniform, not to have one district tax at one rate, and another district at another.

There was proof about some district in California having a rate that was different from the rate in some other State.

Senator HERRING. And the tax was to apply on the new part but not on the repaired unit.

Mr. DAUBIN. That was our understanding.

Mr. Van Alen, the secretary of our association, in California, was before you, also, and ex-Congressman Dockweiler came before the committee.

On that point I would like to read just one paragraph from the House hearings on this 1942 revenue bill, volume II, page 1920; when we appeared before the House Ways and Means Committee just recently Mr. Robertson, of Virginia, stated this, at page 1920:

> In connection with this matter on which we had a hearing, Mr. Van Alen, of Los Angeles, wrote each member of the committee a letter urging that no tax be levied on parts taken from dismantled cars and used for repair or reconditioning purposes. We had quite a bit of discussion on this subject in executive session, and that time we yielded to the request of the Treasury officials who said, "We will handle this by regulation." They said that if they found that a unit used was a repaired unit it would be subject to no tax, but that if it was a new unit it would be subject to the tax, even though it is made out of parts that were previously used. That is the way we left the matter when the bill was presented to the House. When the bill went to the Senate Secretary Morgenthau made his statement, and the first witness to be heard by the Senate committee was Representative Dockweiler on this very point. That will be found on page 55 of the Senate hearings of the 1941 Revenue Act. Mr. Dockweiler proposed to the Senate committee an amendment in the following language: "And other repair, overhauling, or rebuilding parts or accessories when sold as such."

Senator BROWN. It seems to me, Mr. Daubin, that you have made a pretty good case. You need not say anything more.

Mr. DAUBIN. Can I take that as a vote of the committee now? I will be willing to accept it.

Senator BROWN. It is just a suggestion.

Mr. DAUBIN. I yield to the suggestion. I hope you will remember that in executive session.

The CHAIRMAN. Thank you, sir.

Mr. DAUBIN. I might add, when the directors——

Senator BROWN. Now, now, now——

Senator HERRING. Mr. Chairman, he is a lawyer.

Mr. DAUBIN. Mr. A. S. Holzwasser, the next witness, a director of our association, from Boston, could not attend, and Mr. Goldman, who is a director of our association and operates in Baltimore, would like to make a short statement in his place.

The CHAIRMAN. All right, Mr. Goldman.

STATEMENT OF ALBERT D. GOLDMAN, BALTIMORE, MD., DIRECTOR, AUTOMOTIVE PARTS REBUILDERS ASSOCIATION

Mr. GOLDMAN. Mr. Chairman, my name is Albert D. Goldman, and I appear as a member of the Automotive Parts Rebuilders Association, who ask for a clarification of the manufacturers' excise tax, section 3403 (c), United States Code, as it pertains to automobile parts.

There are many hundreds of small firms engaged in this business of reconditioning automobile units who face a loss of their life's work because of this confused tax situation.

I appear as a working member of a small firm engaged in the reconditioning of automobile units. We have never considered ourselves manufacturers of automobile parts. Our customers have not considered us manufacturers, and not even the deputy of the Treasury Department in 1933 who inspected our premises considered us manufacturers. However, about 2 years ago, a deputy from the local Baltimore office visited us, placed an assessment which is tremendous, that is to us. A tax bill, plus interest and penalties, that amounts to a confiscation of our business. In questioning him whether this was a tax that should be placed on us, whether we were liable, he stated that he did not know anything about this type of business. We wanted to show him through our premises, so that he could ascertain whether the tax applied to us.

He said all his orders were to place an assessment on us, which he did.

Last year when we appeared before you gentleman, we brought certain samples to show just what kind of work we did.

Small firms who are engaged in our business are, at this time, considered very important to the national economy. The Brookings Institution survey shows that there is a minimum of 20,000,000 vehicles to be kept in running condition. According to the War Production Board this problem has been placed on our shoulders, and they have given us an A-1-A priority rating to go on with our work.

We do not come before you to ask for a reduction in tax, or a smaller tax; we just ask that a clarification be given, because unless something is done about that, we are going to be forced out of business. If it is essential to place a tax on this type of business, place it on the basis of repairs and state that they are for repairs and not for this confused situation which is threatening us.

The CHAIRMAN. I do not think this committee ever wanted to tax the labor that went into the assembling, cleaning, and repairing of these parts and accessories, and we thought we had taken care of it, as you heard from the conversation with Mr. Daubin when he was on the stand, but apparently we have not.

Is there something else you wish to submit at this time?

Mr. GOLDMAN. No. But I want to urge upon you gentlemen—I am not talking for myself, nor for our group, but as far as the economy is concerned of the transportation system, it is, at this time, very difficult to operate even under normal conditions unless we get some relief from this situation, a great many more people are going to be forced out of this kind of business.

Within the last year, or year and a half, a great many small concerns have already been forced out of business because of conditions.

The CHAIRMAN. Yes, sir.

Well, we thank you very much.

Mr. GOLDMAN. Thank you.

The CHAIRMAN. We have one other witness on this point, Mr. Rosenberg.

STATEMENT OF AARON ROSENBERG, DETROIT, MICH., REPRESENTING DETROIT NEW AND USED PARTS DEALERS ASSOCIATION

Mr. ROSENBERG. Mr. Chairman and members of the committee, I will present this problem from a slightly different angle. My name is Aaron Rosenberg. I am an attorney with offices in the National Bank Building, Detroit, Mich. I am counsel for the Detroit New and Used Parts Dealers Association, consisting of retailers of new and used parts and car wreckers.

I appear in reference to section 3403 (c) of the Internal Revenue Code.

I feel that I should make a brief statement about the industry I represent, so that you, Mr. Chairman, and the gentlemen of the committee, who probably had no contact with this industry will gain some familiarity with it.

Fortunately, or unfortunately, there are millions of car owners in the United States who would under certain conditions not drive their cars if they did not depend upon the used parts dealer.

The used parts dealer is, as some departments of the Government call him for the purpose of obtaining scrap from him for the war effort, the auto graveyard owner. He buys wrecked cars either directly from the owners or from the car dealers who accept so-called jalopies in trade for a new car. This car is dismantled, the scrap and steel is sold to junk dealers and some of the parts are salvaged. The important parts are the transmission, rear axle, also known as the carrier, carburetor, and so forth.

These salvaged parts, the transmission, the axle, or whatever part is removed from the wrecked car, is dipped into a degreaser and the dirt, grease, rust, and corrosion is removed by an acid. After same is removed from the degreaser, it is examined by a mechanic, who also waits upon customers at the counter, and if he finds everything in good order he puts the part away in a bin. If, on the other hand, he finds that the part needs a new gasket, a new gear or bearing, such new part is installed. I also wish to draw the attention of this committee to the fact that the manufacturers' excise tax was paid for such new part when same was purchased by the wrecker.

This operation in no way changes the appearance or identity of the part so repaired. It is sold as a repaired automobile transmission or axle as the case may be.

It is impossible for a wrecker to use, for example, a gear or a pinion from a Plymouth transmission in a Buick transmission. What I am trying to bring out is that the automobile parts are not dismantled and their component parts sorted out but each automotive part removed from a wrecked car is treated individually and is repaired in the same way and manner as a garageman would repair such a part. No part of replacements or any other part of the item being repaired is manufactured by the wrecker. The service rendered by the wrecker is purely one of "labor" in the unskilled class. The wrecker does not build used or new parts, is not equipped to make, manufacture, or produce new parts and does not have the skilled mechanical help to build or create new parts. Furthermore, the wrecker does not make major repairs since those items, which cannot be made to function or work, are junked. The wrecker does not have dies, stamps, or machinery necessary to make or manufacture any automotive parts. The repaired item is then sold to a customer for which the customer pays a certain amount in cash plus his old part known as an exchange. A credit is given him for such exchange, which exchange is usually junked. Such exchange has very little value to the wrecker for its condition is such that it is either beyond repair or it would be too costly to repair it. However, the customer received a credit for such exchange and same is noted on the sales slip issued to him. This is being done, in most instances, to make the customer feel happy that he received a trade-in allowance for an almost worthless item. The value given to the item, however, is a fictitious one.

The Internal Revenue Bureau and particularly the local collector, as in our own city of Detroit, the cradle of the automotive industry, have their own views and their own interpretations of this section of the Internal Revenue code. They make their assessment on the repaired part, which was taxed once before—the new part that was used to repair the old part and the exchange. They merely check the sales slip and wherever they see the item transmission or carrier, they are not interested whether the part was sold as used or repaired, that new tax-paid parts were used in the process of repairing, that the exchange was merely a sales device, but they assess the whole thing—hook, line, and sinker.

To give you, Mr. Chairman and gentlemen, an example, I will cite the case of Mr. Sam Kaufer of the East Side Auto Parts Co.

of Detroit—Mr. Kaufer is the gentleman who was delegated by the Detroit Association to accompany me as technical adviser. In case any of you gentlemen may want to know some of the mechanics of dismantling or repairing of an automobile, Mr. Kaufer is more competent to answer these questions than myself.

In November 1941 two field men from the Detroit office came into Mr. Kaufer's store—demanded that he turn over to them all of his sales slips. They spent about a week on the premises and then they took the slips to their headquarters. Within a month Mr. Kaufer received an assessment totaling $2,300, including tax on every transmission, every carrier, used or repaired, that they found on these sales slips—taxing every exchange, setting an arbitrary figure of $5 for every exchange, plus interest and penalties since 1937. We have argued with these men, we tried to show them that we are just repairmen.

We asked them to check our process of repair. We explained to them that every item we repair is individually repaired and treated. In my capacity as attorney for the association I tried to argue that the Bureau conceded on many occasions that repairing and reconditioning one unit at a time is "repair, not taxable"—but this did not help us.

We were assessed and we are still assessed today. In order to stay distraint proceedings, which would ruin our business, we filed an abatement claim with the Miscellaneous Tax Division at Washington. We were obliged to file a bond at great expense and inconvenience. We are hoping for a hearing or a clarification of section 3403 of the United States Code.

For the sake of brevity, I am only citing one example. I could go on and on and cite to you gentlemen the conflicting opinions and interpretations of the various administrators and collectors. However, I wish to emphasize, Mr. Chairman and gentlemen, that the repairer of automobile parts is not a manufacturer; that it was not the intent of your committee to tax a repairman.

Words and Phrases, volume 4, page 273, distinguishes manufacturing from repairing as follows:

> * * * "manufacturing" is the system of industry which produces manufactured articles and "manufacture" is the production of articles for use from raw or prepared materials, by giving them new forms, qualities, and properties, or combinations, and "repairing" is the making or restoring of an article or thing to its completeness.

The wrecker or used parts dealer comes within the purview of this definition. He is nothing but a repairer. He is anything but a manufacturer, and he should therefore not have to pay a manufacturer's excise tax, particularly on parts that are tax-paid. For under the present rulings, every time a wrecker repairs a part he pays a tax on it and if that part is repaired 10 times he would be obliged to pay 10 times the excise tax.

We haven't collected this tax from our customers in 1937 nor in any of the years following it. Nor are we collecting the tax today. Although the local collectors classify us as manufacturers, our customers still look upon us as wreckers and repairers and think that we are off our mind when we suggest to them that they have to pay a manufacturers' excise tax on parts repaired in our place.

We are the Dr. Jekylls and Mr. Hydes of the automotive industry. When we dismantle a car we are nothing but auto graveyard operators. However, as soon as we take the part salvaged and clean it and add a gasket or a bearing to it and thus make it look decent we are manufacturers.

Mr. Chairman and gentlemen of the committee, we ask you to clarify this situation by amending the law so that we are what we are and have the act read, "including in each of the above cases parts or accessories other than repaired, reconditioned, or rebuilt parts."

I want to add a brief statement. Particularly now, when the manufacture of automobile parts has completely stopped, our industry, is not in unfair competition with the manufacturers of new auto parts. On the contrary, by scrapping old cars we are furnishing the steel so necessary at the present time.

By repairing old parts, we are keeping the old cars in motion—cars that are needed so badly now to transport workers to the plants that are contributing to the war effort.

We feel that, as a group, we are making a definite contribution to American economy and are therefore, asking you gentlemen to amend the excise tax law so that at least we may know our status.

The CHAIRMAN. Thank you very much.

Congressman Dewey.

STATEMENT OF HON. CHARLES S. DEWEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

The CHAIRMAN. Congressman, we will be very glad to hear you at this time.

Mr. DEWEY. My name is Charles S. Dewey, Member of Congress from the Ninth Congressional District of Illinois.

Mr. Chairman and gentlemen, I wish to thank you very much indeed for giving me the opportunity to appear before you, and I will make my remarks as brief as possible. I would like to ask consent, at the termination of such remarks as I make, that I might have included in the hearings, the remarks I made yesterday on the floor in regard to the post-war credit.

They are contained in the Congressional Record.

The CHAIRMAN. You may do so.

Mr. DEWEY. Thank you, Mr. Chairman.

Mr. Chairman and gentlemen, all the proposals that I have studied in regard to the so-called post-war credit appear to me to have certain faults and do not go far enough.

Among the proposals I have studied that have been offered to the Ways and Means Committee, and by the Joint Committee on Taxation, there has been suggested an immediate cash credit; now to me, an immediate cash credit being paid to the payers of excess-profits taxes might place too great a burden on the Treasury, if it were paid immediately after the cessation of hostilities. Also it would be very difficult to control the uses of such cash as was suggested in the various proposals. Namely, no such cash to be used for the payment of dividends nor the buying of stock, nor the payment of bonuses or salary increases to executives nor increas-

ing cash reserves, unless employed in the business, nor to purchase securities.

I think it would be very difficult to control any cash payment, and I think it also might place a great burden on the Treasury to make such a cash payment.

Second, if there was an issuance of an ordinary Government security, I think that the issuance of such security to the payers of the excess-profits tax might cause an unsettlement of the bond market, for the simple reason that they would probably wish to sell those securities to derive cash for their business and if they did sell them there would be a pressure on the bond market; and, further, the cash derived would also be hard to control for the purposes that I have just mentioned.

Third, if there was an issuance of bonds or certificates over a scheduled number of years, as has also been proposed, there is no possible way of ascertaining in advance, if those scheduled payments would fall at a time when the industries were greatest in need of assistance. One can never tell that. In the two proposals, one of the first payments was to fall within 2 years after the cessation of hostilities and in another proposal it would fall 3 years afterward, then 4, then 5, and then 6 years, but who could tell if, after 2 years, the industries would be most in need at that time. Probably their needs might have been greater a little before that time. Lastly, and of great importance, the post-war credit has only been considered to go to those who have paid excess-profits taxes, and I do not think that that goes far enough.

Senator TAFT. You are referring to the post-war credit provision in the House bill?

Mr. DEWEY. I am referring to the post-war credit provision in the House bill; yes.

Senator TAFT. Which was taken out on the floor of the House?

Mr. DEWEY. Yes, sir.

I think that if there is to be a post-war credit to corporations, it ought also to be extended to those that paid a surtax, for the simple reason that since, in the existing revenue law, the surtax rate is only 7 percent. It is now proposed to raise it by 21 points, or an increase of 14 points.

Now, that seems to me to be a "minimum" excess-profits tax paid by everyone.

The surtax as proposed is raised from a high bracket of 60 percent in the existing law, to 90 percent. That is an increase of 30 percent.

Now, I do not know what the proper credit would be to allow to the payers of excess-profits tax and surtax payers, but there is a relationship between the two. I offered in my proposal that all those people paying a surtax should be allowed a post-war credit of 3 percent, in each taxpaying year of the surtax paid, or, if you figure it in another way, it might be 5 percent, that is on the basis that 10 percent credit is going to be paid to the payers of the excess-profits tax. There is a relationship there between these two taxes, even if a great many of the smaller companies that will not pay an excess-profits tax, because they have probably not had any war contracts.

But, I think their future financial condition should be taken into account. Those little companies will need just as much assistance as

the larger ones, and I think, if this committee, in its wisdom decides to consider the post-war credit, consideration should be given to assisting smaller companies that merely pay a surtax as well as the larger companies doing war business that pay an excess-profits tax

I offer, as a proposal for the consideration of your committee, sir, the issuance to corporations paying an excess-profits tax bonds in an amount equal to the excess over 80 percent of the taxpayer's adjusted excess-profits net income, and to corporations paying surtax, the issuance of bonds in an amount equal to 3 percent of such tax.

As I have said, after consideration, that you might wish to raise that to 5 percent, but I offer now the 3 percent.

I also suggest that these bonds that are to be issued be serial issues for each tax year, and at the time of issue they will be nonnegotiable and noninterest-bearing and, further, that they will have no fixed maturity, but may be called at the will of the Treasury, 10 years after they become negotiable.

Now, these bonds or certificates, whatever they are named, when received by the taxpayer in any taxable year, may be taken into the financial statement of the recipient corporation for face value, but as a deferred asset. At such time after the cessation of hostilities that the Treasury Department, in collaboration with the Federal Reserve Board, may deem it advisable the bonds or certificates may become negotiable—become a current asset—and then be taken into the financial statement of the recipient corporation as such, as a current asset.

Now, the purpose of that is this: It will be expected that after the termination of this war there may be a great depreciation in value of inventories, and if those bonds can be taken in as a current asset at that time, they may offset the loss in value of the current inventory.

The purpose of the bond is twofold: First, it is a Government obligation. Under certain Federal Reserve regulations which will be promulgated at that time, and pursuant to the restrictions already mentioned, they may serve to secure loans for industrial and rehabilitation purposes; and, secondly, and of equal importance, in order to provide for the marketability and stability of their price, the bonds should be accepted by the Treasury in lieu of cash, to the limit of 10 percent of any tax bill.

Thus, they become a sort of tax warrant, as well as the means of securing commercial loans.

As the bonds will be issued serially, they should only be accepted by the Treasury serially in the payment of taxes.

That is to say, if the 1942 series of these bonds were issued for the 1942 tax bill, after they become negotiable, they might be accepted in 1945, by any taxpayer to the extent of 10 percent of his tax bill.

Series 2 would be accepted in 1946 and series 3 in 1947.

If there are only three series and there are some of these bonds still left outstanding in 1948, they could go back to the excess outstanding of the series 1, and continue the program, say, for the period of 10 years, and at the termination of 10 years the Treasury would have the right to call them.

Now, as to the question of the bond being a nonfixed date or nonmaturity bond. There is no innovation in that among the United States obligations.

I refer to several we have had, but particularly to the 2-percent refunding Consols of 1900 which were callable after 30 years, and were actually called in 1935.

Those bonds were never sold for cash but were delivered to the holders of a number of outstanding issues and had no fixed maturity date.

There is the matter regarding interest. I consider that that is more or less of an administrative matter. The bonds might be given a low rate of interest after becoming negotiable, or they might pay no interest at all, except when they went into the hands of a banker to secure a commercial credit, thereby reducing the cost of the money to the borrower and stimulating their use in the developing of business.

The main purposes of my proposal are as follows: First, to provide a post-war credit.

Senator BROWN. Congressman, how could a nonnegotiable bond be considered a proper security to the bank?

Mr. DEWEY. Under regulations of the Federal Reserve Board they can give complete negotiability as far as loans are concerned.

Senator BROWN. Would it be practically the same as making them negotiable?

Mr. DEWEY. I suppose they are negotiable after the Treasury Department, in collaboration with the Federal Reserve Board would so announce. They are only issued as nonnegotiable at the time of their serial issue to any taxpayer. They would become negotiable immediately after the cessation of hostilities, or at such time as the Federal Reserve Board and Treasury, operating together, would decide, probably taking that date when the crash, if you might call it that, in inventory values had taken place.

That is one of the advantages. If you turn over cash immediately after the cessation of hostilities, why, it might coincide with some post-war buying boom and stimulate it.

Senator HERRING. Congressman, as to its eligibility as an asset afterward, at whatever time it may be determined, do they become eligible to go into the profit-and-loss statement?

Mr. DEWEY. They go into the security account.

Senator HERRING. Not as a profit?

Mr. DEWEY. Not as a profit. They would just be taken up in the assets side of the statement as an investment.

Senator HERRING. I am wondering how, though, if you put it in your statement as an asset, the increase in your assets must be treated as a profit.

Mr. DEWEY. The supposition is that you would have a loss, an offsetting loss in inventories at that time.

Senator HERRING. Then it would go in as a profit?

Mr. DEWEY. Yes; it would be a profit if not offset by an inventory loss. I suppose the excess would go into undivided profits or a special reserve.

Senator HERRING. But the owner would not have the option to put it in as such?

Mr. DEWEY. It would come up from a deferred asset to a current asset at the time that the Treasury Department and Federal Reserve Board would decide, and they would probably decide that it would be at the time when there had been a depreciation in inventory values. The negotiability of the bonds is assured for the simple reason

that they can be used to pay taxes to the extent, as I have said, of 10 percent of an individual's tax bill.

Hence, if they should slip off a little in value, there would be plenty of people who would like to buy some up at a discount and use them to pay taxes with at par, so they would probably keep their value up, if you follow me.

Senator HERRING. I do.

I would like to give some assurance to the words "at the option of the Treasury" so that he will not get part of it back as a profit tax.

Mr. DEWEY. That I naturally could not assure, but I do not think they would be used for that purpose.

They would come in when there would be a considerable loss in inventory, to strengthen the statement of the company by offsetting that inventory loss.

Senator RADCLIFFE. The fact that they have no maturity date, would that have a deterrent effect on their negotiability from a practical standpoint?

Mr. DEWEY. It never had on the 2 percent Consols, sir. There would always, I believe, be a market for them, as soon as they went to a discount, by persons who would like to use them in connection with payments of their taxes.

It would always keep up the demand for them. I believe that that would follow, and there would always be a market for them.

Now, may I say this: The three purposes of this proposal are:

(1) To provide a post-war credit that will come into being when most needed, but at the same time, will not place a too great cash demand upon the Treasury;

(2) To provide a means whereby industry can secure private credit and again work out its individual problems without recourse to Government assistance.

(3) To provide a security that will gradually be retired due to its employment as a tax warrant.

But my basic thought in this whole matter is that having this security, we will stimulate private loans by bankers to provide industry with credit; it will recreate that relationship between private industry and private bankers that has always been in existence; it will permit individuals to work out their own problems rather than to attempt an over-all suggestion by either the Treasury or any other department of the Government, and it starts people back again on their old manner of doing business, financing their requirements and doing it at a time when they think it will be most beneficial to themselves.

That completes my statement, sir, and I wish to thank you very much indeed for the courtesy of being permitted to appear before you.

The CHAIRMAN. Thank you very much.

(The excerpt from the Congressional Record referred to by Mr. Dewey is as follows:)

[From the Congressional Record, August 6, 1942, p. 6988]

POST-WAR CREDITS

Mr. DEWEY. Mr. Speaker, I ask unanimous consent to address the House for 1 minute and to revise and extend my remarks.

The SPEAKER pro tempore. Without objection, it is so ordered.

Mr. DEWEY. Mr. Speaker, during the several months that the 1942 tax bill has been under consideration by the Ways and Means Committee of the House of Representatives considerable discussion developed as to the advisability of introducing some post-war credit provision for those companies which had been subject to the high rates of the excess-profits tax.

The adoption of a post-war credit has a twofold objective. First, to give the corporation an immediate incentive to maintain efficiency and to keep its costs down to a reasonable basis. Second, to provide the corporation with a post-war reserve for rehabilitation purposes.

The Secretary of the Treasury in a statement of March 3, 1942, said, in part:

"Furthermore, after the war there may well be need for a large volume of expenditure in readjusting industry and maintaining employment. For these reasons it is believed desirable that in the case of any dollar of corporate profits, the receipt of which results in an increase in tax beyond perhaps 80 cents, the additional tax on such dollar shall be held by the Government to the account of the corporation and be returnable within a limited period after the war, in those cases where it is spent for new and additional capital equipment or otherwise is spent in the additional employment of labor."

As a basis for study of the post-war credit, a proposal was drafted by the Treasury in collaboration with the Joint Committee on Internal Revenue Taxation, the principal features of which are as follows:

First. The amount to be returned shall be 14 percent—probably now 10 percent as the excess-profits tax is 90 percent instead of 94 percent, as at that time proposed—of the taxpayers' adjusted excess-profits net income.

Second. The amounts shall be set aside in a special fund to be held by the Treasury to the credit of the taxpayer who shall be given a nonnegotiable, noninterest-bearing certificate as evidence of his claim.

Third. The amounts returned to the taxpayer shall be returned in the following manner: First-year collections shall be paid within the third year after the cessation of hostilities; second-year collections within the fourth year; third-year collections within the fifth year; balance within the sixth year after cessation of hostilities.

Fourth. The amounts returned to the taxpayer are intended for use in the conversion of their businesses to peacetime activity or in the maintenance of employment in business activity. To this end the amounts returned shall not be available for the following purposes:

1. The payment of cash or stock dividends.
2. Bonuses or salary increases to executives.
3. The increase of cash reserves unless employed in business.
4. The purchase of securities.

The Ways and Means Committee, after considering the proposal, made a number of technical and administrative changes. While adhering to the principle of a post-war credit and its uses, it set up a different schedule of its payment to the taxpayer, as follows:

First. The bonds shall mature, subject to prior call, as follows:

One-third at the end of the second calendar year following the cessation of hostilities; one-third at the third such year; and one-third at the end of the fourth such year.

Second. The bonds shall be callable upon 3 months' notice at any time prior to maturity date.

Third. The maturity date of all bonds shall be advertised within 30 days after the cessation of hostilities, and in such a way that the maturity date of any bond shall be readily ascertainable.

Neither proposal was actually incorporated in the 1942 tax bill as it was reported to the House. The entire matter will have to be reconsidered by the Senate Finance Committee and the Senate.

I have given the whole subject of the post-war credit considerable thought and study. I believe that its introduction into the pending tax bill will give the corporations operating in national defense contracts an immediate incentive to maintain efficiency and keep the costs down and provide them with a post-war reserve for rehabilitation purposes.

On the other hand, its omission may have a deleterious effect on the economical methods and counting of costs in American industry which will be so necessary if we are to meet post-war competition. As I pointed out in addressing the House on July 17:

"Once a manufacturing firm is well past its standard revenue it can derive no further financial advantage from a well-planned business effort. On the other

hand, in fact, it can avoid any financial loss, even if its efforts are badly planned. So far as extra receipts above his standard revenue are concerned, the money which the businessman is administering is not his own but really belongs to the Government, and the businessman is suddenly placed in the position of being a civil servant handling public funds, although he is not trained as such and will not be subject to the same supervision necessary in the case of people who administer public money."

While the post-war credit will serve the purposes of stimulating incentive and providing certain reserves for post-war rehabilitation, it cannot be expected to become a cure-all and by itself completely save the American economy from the aftermath of the dislocations that have occurred due to our war effort.

I have noted in the testimony of one of the witnesses that it is expected that some 18,000,000 men will have great difficulty in finding work, but that if a $3,000,000,000 post-war reserve is immediately pumped into the industrial bloodstream a good many jobs can be afforded. I fear that this thought is a little overoptimistic.

The figures taken from the July Federal Reserve Bulletin show that the average wage rate for factory workers working 42 hours a week is 81.9 cents per hour. If 18,000,000 workers were each paid 81.9 cents per hour, there would be a total wage bill of $14,760,000 per hour. This sum, divided into the $3,000,000,000 that might be available as a post-war credit for industry, would provide 203 hours or about 5 weeks of work for the 18,000,000 excess workers.

However, as the census data shows wages constitute only about 40 percent of the value added by all manufacturing operations, the $3,000,000,000 of credit would actually provide but about 2 weeks' work for the above-mentioned 18,000,000 excess workers seeking jobs.

There will undoubtedly be a great need for Government assistance after the cessation of hostilities to both our national and international economy. But it is my fond hope that once priorities are relaxed and the business of the United States goes back again to supplying requirements of the civilian economy, business will again attempt to depend upon its own initiative and not be constantly coming to the Federal Treasury for support.

The proposals for a post-war credit so far presented to the Congress contemplate the payment of funds out of the Treasury over a period of several years following the cessation of hostilities.

Two questions immediately arise: Might not the redemption of bonds issued as evidence of a post-war credit embarrass Treasury financial operations at a time when normal demands upon the Treasury will be very great? Also, who can tell if the schedule of payments as contained in the proposed plans will coincide with the periods when the rehabilitation needs of business are the greatest?

It is well remembered that after the first World War there was a post-war buying boom followed by a depression. An immediate payment of the post-war credit might coincide with this post-war boom and even have the effect of stimulating it.

In lieu of issuing as a post-war credit either a bond with a fixed callable date or an ordinary obligation of the Treasury, I offer the following proposal:

First. The issuance to each taxpayer of a perpetual nonnegotiable, non-interest-bearing certificate in the amount of 10 percent of the total amount of excess-profits taxes paid by him in each taxable year during the period of the war, those certificates issued for the taxable year of 1942 to be called series 1; for 1943, series 2; 1944, series 3, etc. The certificates are to be callable at the will of the Treasury 10 years after becoming negotiable as hereinafter provided.

Note to first: The recipient of any such certificates may carry them in his statement as a deferred asset in the amount of their face value.

Second. At such time as the Treasury, in collaboration with the Federal Reserve Board, shall decide and publicly announce, the said certificates shall become negotiable and may be carried in the statement as a current asset.

Note to second: It is most probable that upon the cessation of hostilities there may be a buying boom followed by a collapse in the value of inventories, or, in fact, there may be a collapse in the value of inventories without any buying boom. If the post-war certificates can at this time be taken into the current assets of the statement, they will offset to at least a degree such inventory losses.

Third. Purpose and uses of the certificate:

(*a*) The certificates, being a Government obligation, will have a loan value on the same basis as any other Government obligation and may be hypothecated

with banks to secure loans for commercial purposes under such regulations as the Federal Reserve Board will provide.

Note to (*a*): The restoration of private initiative among the industry of the country will be more quickly obtained by providing them with the means of obtaining credit with which to work out their individual problems and thereby doing their part to solve the unemployment question than through resorting to the old policy of pump priming.

(*b*) In order to maintain the negotiability and a market for the certificates and to maintain their price level, even should they bear but a low interest rate or none at all, the certificates should be acceptable by the Treasury in the payment of taxes. Provided, however, that in payment of any tax bill only 10 percent may be represented by the said ceritficates and the balance of the 90 percent be paid in cash. Further, in order that the Treasury may have some estimate of its tax receipts in cash and in certificates, series 1, as mentioned above, of said certificates may be used for tax payments in a certain specified taxale year; series 2 in the following taxable year; series 3 in the third taxable year, and so forth.

Should there be but three series of certificates and an excess of series 1 remains outstanding, it could be used in the fourth taxable year and the excess of series 2 used in the fifth taxable year, and so forth. The supposition being that by the end of the tenth year most, if not all of the certificates, would have been redeemed by the Treasury in lieu of cash payments and the Treasury would have then the power to call any balance outstanding.

Fourth. The question of paying interest on these certificates is an administrative matter. It might be suggested, however, that they bear no interest at all while being held by the taxpayer, but if and when hypothecated with a bank to secure a commercial loan the borrower would pay 1¼ percent interest under the "going" rate and the lender would bill the Treasury Department for 1¼ percent during the life of the loan.

Certain objections have been raised that a post-war credit based on a return of a certain percentage of excess-profits taxes would benefit only the larger corporations and businesses.

There is no reason, however, that the same system of setting up a post-war credit but at a lower percentage, cannot be logically extended to those corporations paying surtax. As a matter of fact the 14 percent absolute increase above rate of 7-percent surtax under the existing law to 21 percent surtax rate under the proposed law really represents a minimum excess-profits tax and should be so considered. If so, consideration should be given to setting up a 3-percent post-war surtax reserve out of the surtaxes paid by smaller corporations. This figure of 3 percent is derived in the following manner:

The rise of 14 percent in surtax is in reality a minimum excess-profits tax paid by all corporations. A corporation paying the excess-profits tax must also pay the surtax—14 percent of which is the minimum excess-profits tax above mentioned—as well as the excess-profits tax itself, which has risen 30 percent absolute, making a total rise of 44 percent.

The 14 percent rise in surtax is about one-third of the total rise of 44 percent charged the excess profits taxpayer. Hence, if the post-war credit is extended to those paying a surtax but no excess profits tax, such credit should be one-third of the 10 percent credit proposed for the excess profits taxpayer, that is to say, 3 percent.

Nonmaturity obligations are no innovation in the history of American finance. In March 1900 a refunding of a number of outstanding loans was made in the form of 2-percent consols of 1930, of which 646,000,000 were issued in the refunding operation.

The 2 percent consols had no fixed maturity but were callable at the will of the Treasury after April 1, 1930. As a matter of fact, they were finally retired in 1937.

The same type of nonmaturity consols was issued by the British Treasury for many years as well as the rentes by the French Treasury, and certainly there is no innovation in the use of Government securities to secure private loans.

I believe that any post-war plan should contemplate the reestablishment of private bank credit extended to corporate borrowers. No one can deny that the economic development of the United States was principally based upon the credit relationship that existed between local industry and local banks, and any post-war rehabilitation plan must take into consideration the return to normal practices, by which private industry may obtain private credit for its commercial require-

ments. In my opinion, given the opportunity, business will again turn to the ordinary sources of credit rather than to constantly look to the Treasury for support at a time when the Treasury itself may have numerous demands upon it.

The CHAIRMAN. Mr. Zens.

STATEMENT OF PAUL ZENS, PHILADELPHIA, PA., REPRESENTING BUDD INTERNATIONAL CORPORATION

Mr. ZENS. My name is Paul Zens. I am treasurer of the Budd International Corporation, a subsidiary of the Edward G. Budd Manufacturing Co., of Philadelphia.

I am here because of the retroactive features of the 1936 undistributed-profits tax, which has placed us in a very embarrassing and unbearable position.

Briefly, it amounts to this: The Commissioner of Internal Revenue has imposed an undistributed-profits tax of approximately $600,000 for not distributing something we did not get, we did not have, nor did we have any control over.

I have a brief statement here which summarizes the transaction, which I would like to read to the committee for the record and for your consideration.

The CHAIRMAN. Yes, sir. You may proceed, Mr. Zens.

Mr. ZENS. The Budd International Corporation owned stock of an English company which stock the Board of Tax Appeals treated as having had a tax basis of $1,000,000. English banking interests owned 90 percent of the preferred stock of Budd International, and by reason of default in preferred dividends had the voting control in Budd International disposition of the Budd International Corporation's investment in the stock of the English company, but only upon condition that the bulk of the proceeds be used to retire the preferred stock. In February 1936, before there was any inkling to the public of the possibility of an undistributed-profits tax, the sale was consummated, on which a profit of $5,000,000 was determined.

The preferred stock was immediately retired from the proceeds, and the balance of the proceeds was used as a reserve for the normal tax and the declaration of a common dividend.

The proceeds of the sale were disbursed as follows:

Proceeds of sale of stock		$6,083,780.05
Expenses of sale		252,789.71
Total		5,830,990.34
Retirement of 76,572 shares of preferred stock at $57		4,364,605.00
Total		1,466,385.34
Reserve for Federal normal tax ($633,844.76) paid when returned filed) and Pennsylvania taxe	$811,000	
Common dividend	654,858	
		1,465,858.00
Total		528.34

In June 1936, 3 months after the sale and the disposition of the proceeds as aforesaid, the Undistributed Profits Tax Act was passed, but at that time the company's other assets had become of no market value, so that, during the balance of 1936, the company had no assets remaining of any substantial value which could have been used by it to declare further dividends and thus prevent the application of the penalty provisions of that act.

Such remaining assets consisted entirely of certain patents and patent rights in Europe (the company's cash and accounts receivable being less than its tax liability for Federal normal and Pennsylvania taxes), and the stock of Ambi-Budd Presswerk G. m. b. H., a German corporation located at Johannesthal, Germany. Although the company made strenuous efforts to sell these assets, due to the disturbed conditions in Europe, it was not able to do so or to borrow anything thereon.

An undistributed-profits tax, with interest, aggregating upward of $800,000 has been determined because an amount equal to the determined profit from the sale in January 1936 was not distributed as a taxable dividend.

My understanding is that the only possibility for any relief under this situation, is to amend the act, and we are proposing amending the act, making it retroactive to May 1, 1936, instead of January 1.

I would like to submit this for your consideration. It is a case where we are entitled to serious consideration. It is, I think, a very unjust tax.

The amendment referred to is as follows:

The Revenue Act of 1936 is hereby amended by adding the following subsection at the end of section 26 (c) (3):

"(4) In the case of a corporation which, prior to May 1, 1936, has realized gain from the sale or other disposition of a capital asset and has, prior to May 1, 1936, distributed the proceeds, or any part thereof, of such sale or other disposition to its shareholders of any class or classes, the amount so distributed (to the extent of the gain recognized on such sale or other disposition, less the amount of dividends paid credit thereafter available to it in 1936 but not availed of), shall be allowed as a credit to the extent not otherwise allowable as a credit under any other provision of this section or of section 27."

This amendment shall not apply to any case with respect to which, at the date of enactment of this amendment, a closing agreement has been made under section 3760 or a decision of the Board of Tax Appeals or a judgment by any court of competent jurisdiction has become final.

The undistributed-profits tax was first suggested in the President's message of March 3, 1936. May 1 is the date fixed by Congress in section 27 as the deadline for contracts precluding dividends.

An alternative amendment is as follows:

The Revenue Act of 1936 is hereby amended by adding the following subsection at the end of section 26 (c) (3):

"(4) In the case of a corporation which, prior to May 1, 1936, has realized gain from the sale or other disposition of a capital asset and has, prior to May 1, 1936, distributed the proceeds or any part thereof, of such sale or other disposition to its shareholders of any class or classes, the amount so distributed (to the extent of the gain recognized on such sale or other disposition, less the maximum fair market value in 1936 after such distribution of the net assets owned by the corporation in 1936 after such distribution which it might have distributed but did not distribute in dividends to its stockholders during 1936) shall be allowed as a credit to the extent not otherwise allowable as a credit under any other provision of this section or of section 27."

This amendment shall not apply to any case with respect to which, at the date of enactment of this amendment, a closing agreement has been made under section 3760 or a decision of the Board of Tax Appeals or a judgment by any court of competent jurisdiction has become final.

The CHAIRMAN. Have you conferred with the Treasury on this matter?

Mr. ZENS. I am very glad that you asked that question. We have. Our counsel has been in touch with them. I think they are sympathetic, and I would be very glad to have you and your committee get

in touch with Mr. Tarleau and Mr. Surrey. Mr. Stam is entirely familiar with it.

As a matter of fact, it was suggested by them that the relief be obtained by an amendment to the act.

Senator TAFT. Are there other companies in the same situation? Is that a general fault in the act?

Mr. ZENS. Yes; that is the general fault. I do not know of another single case that is similar.

Senator CONNALLY. You have an English company and an American company?

Mr. ZENS. We had an English company, which we sold, and have a German company. Of course, we have not been able to sell the German company.

Senator CONNALLY. They are all the same stockholders, are they?

Mr. ZENS. The Edward G. Budd Manufacturing Co. controlled the English company as well as controlling the German company. The purpose of those companies was to sell the Budd all-steel body to manufacturers of automobiles in Europe, practically all of them using that type of body.

Senator CONNALLY. Why did you decide to sell the English company?

Mr. ZENS. For two reasons: We were somewhat worried about the European situation; secondly, the Budd Manufacturing Co., of Philadelphia, had some very tough years during the depression and we were looking for additional working capital.

Senator TAFT. You mean you held the preferred stock?

Mr. ZENS. We held the preferred and common stock of Budd International Corporation.

Senator TAFT. You say the English banks controlled part of the preferred stock?

Mr. ZENS. What happened, Senator, was this: The English company was sold for $6,000,000. J. Henry Schroeder, of London, a banking house, had $4,000,000, approximately, of the preferred stock, and the Budd International, which company controls the Budd International, the manufacturing company, had $350,000 of the preferred stock of Budd International.

Negotiations started in November 1935. The deal was pretty well set by the end of the year. The difficulty at that time was getting the Bank of England to agree to the transfer or exchange. They finally took this position, they said, "Here is an English-owned company, selling for $6,000,000 and there is $4,000,000 of English money in it. Now we are not going to permit the transfer of the $6,000,000, but if you retire the preferred stock, of the J. Henry Schroeder Co., then we will permit you to transfer the balance." I think, under the circumstances existing in England at that time, the bank was absolutely justified.

Senator TAFT. Are there any assets in the company now? Any assets that amount to anything?

Mr. ZENS. We own the German company. I think the physical assets before the war were about $3,000,000. We have not heard anything about that since July 1939. We own and control a great many European patents.

The CHAIRMAN. We will be glad to give you consideration.

Mr. Hooper.

STATEMENT OF JOHN W. HOOPER, BROOKLYN, N. Y., REPRESENTING BROOKLYN CHAMBER OF COMMERCE

Mr. HOOPER. I am John W. Hooper, appearing for the Brooklyn Chamber of Commerce, Brooklyn.

The CHAIRMAN. You may proceed.

Mr. HOOPER. The Brooklyn Chamber of Commerce is thankful for this opportunity of again presenting the view of the business and manufacturing community of Brooklyn, N. Y., on the subject of Federal taxation as it exists today and as proposed in the revenue bill of 1942, H. R. 7378.

The Brooklyn Chamber of Commerce, as an organization whose membership is made up of manufacturers, mercantile houses and professional people, is highly conscious of its responsibility because of the very active part that it has taken and is taking in assisting in the distribution of war work among the members of the business community whether members of the chamber or not. This work has been carried on from the very beginning when national defense work was initiated. The chamber reorganized its facilities and staff in order to concentrate its effort upon maximum industrial mobilization for war production.

Extensive services for information and guidance were set up and are constantly being used by manufacturers large and small. The leading industrial and professional people of Brooklyn, in inducing the chamber to enlarge the scope of the services, were conscious of the need of it because Brooklyn is essentially a concentration of small industries probably unequaled in any other community of the country. The concern of the chamber has been not only to help produce more for victory but also to do everything practicable to assure the survival of small industries in this critical period.

In this connection, it is of interest to note that more than 500 local plants are now producing under primary contracts or subcontracts. Since the chamber is interested in the present maximum production and ultimate survival of these businesses, it must take cognizance of the effects of present taxes and proposals of new taxes.

In making the suggestions and statements hereinafter expressed we have in mind not only their direct effect upon the small as well as large manufacturers, but also their relation to the crisis that faces the buying power of the dollar, and to the continuance of our basic customary ways of life and doing business. Accordingly, the statements herein are made in full sympathy for the Senate Finance Committee as it meets the serious problems with which it is confronted.

H. R. 7378 gives evidence in part of understanding and meeting of the crucial financial problems before us, and in part of failure so to understand and meet them.

To save the time of the committee we will comment, orally, only on the high spots of the general financial problems and proposed legislation and concomitant need for revision of existing legislation. Therefore, we ask permission to place in the record a list of other changes—and the reasons therefor—that we believe should be made in H. R. 7378 and in existing law.

A good job has been done by the Congressional Joint Committee on Nonessential Expenditures in effecting economies in civil expenditure but the job should not be considered finished.

The savings given effect are slightly in excess of $1,300,000,000 but when one realizes that the expenditures for the civil arm of the Government have risen from $2,200,000,000 in 1928 to $7,300,000,000 in 1941 it is not unreasonable to assume that there is still a good deal of costly Government activity being carried on that is unrelated to the successful prosecution of the war and therefore should be eliminated. It is the opinion of the Brooklyn Chamber of Commerce that at least $1,200,000,000 more should be lopped off the Budget for 1943.

If we would but close our ears to the advocates of sociological experiments, the problem of the reduction of the Budget of civil expenditures would not only be made easy but the accomplishments would be a heartening reassurance to the taxpayers of the Nation that the administration is willing to give up all of such experiments in the interest of winning the war.

The Ways and Means Committee has devoted a great deal of time in the preparation of H. R. 7378. Today we are looking to the Senate to make proper amendments to the bill so that business shall not be strangled and war production consequently impeded.

Destructive effects of high tax rates.—The proposed 45-percent tax on the normal incomes of corporations not only will make it impossible for business companies to survive as independent entities, but it deliberately places another inequitable burden on the investing public as a class.

It is the investing public that still has faith in the enterprise system. Investors are being heavily taxed and will be more heavily taxed under the proposed Revenue Act of 1942 on the dividend income that they may receive. Even under the Revenue Ace of 1941, very little incentive to investment is left if one figures the direct and indirect effect of taxes on investment income.

The proposed Revenue Act of 1942 obliterates all vestige of incentive for enterprise capital outside of the hope that, at some distant future date equities may be found to have survived taxation and the inflation with which our monetary system is now threatened. It is the confirmed opinion of Brooklyn business that the tax on normal incomes of corporations should not be increased beyond the 31 percent fixed in the Revenue Act of 1941 unless it be by 2 percentage points to make up for the loss of revenue if the Senate should adopt the Treasury recommendation to repeal the capital-stock tax and declared value excess-profits tax.

If there must be further tax revenues from corporate activities to assist in financing the war, then we say to you get the tax from those benefiting from the activities of the corporations, namely, the stockholders and the employees, without further depletion of the normal earnings which corporations need for financing and protection. The effect of higher taxes on normal corporate earnings will be further cutting of dividends by established dividend-paying companies partly because of the impact of taxes on normal income and partly because of the need for creating and using reserves to pay for financing the participation of those companies in the war-production effort.

As to the excess-profits tax, we submit that a 90-percent rate, as proposed, will be absolutely ruinous, particularly to those small companies which are participating or trying to participate in the war effort but whose financial sinews are such that they must borrow to finance their war work.

Strange as it may seem, officers of many small businesses have been slow to realize the effect of the impact of the proposed taxes on their businesses. Many are not yet aware that, should H. R. 7378 be enacted, they will be called upon, in effect, to pay a dividend to the Government of from 45 to 90 percent of their profits when they would not dream of paying such a dividend to stockholders if doing so would oblige them to borrow the money to do it.

It must be remembered that today profits are largely book profits tied up in increased receivables, inventories, and equipment, and to that extent are not available in cash for payment of taxes or dividends.

When a business is obliged to borrow money to pay taxes on profits that are tied up, due to war production, the Government, in effect, is requiring the business to pledge its own credit to raise the money needed to prosecute the war. Banks and other loaning institutions will have to wait for repayment of the loans until the time comes, if ever, when the borrower can turn into cash the increases in the assets on which he has had to pay taxes. To the extent that the taxpayer will not be able to realize the cost to him of the increase in the receivables, inventories, and plant, he will be obliged to use his reserves, if any, to pay off his loans. Should his reserves be insufficient, then the borrower will be faced with insolvency.

A survey which we have made of representative companies both small and large, engaged in war business, confirms the foregoing statements without the slightest shadow of a doubt. We expect to present the results of this survey shortly in a separate memorandum.

Recommendation re tax rates.—Looking at the matter broadly and realistically, our view of the situation is that the year 1941 was the year of preliminary introduction of war business as a whole, and that the year 1942 is the year of conversion, the year of general change of industry from a peace to a war basis, with its concomitant increase in working and plant assets. In the transitional period of conversion business needs understanding and consideration. Business profits made during 1942 will be basically book profits, because, as previously stated, they will be found to have been plowed back into increased receivables, inventories, and equipment, not for peace purposes but for war purposes.

Therefore, we suggest that the revenue rates for 1941 as applied to excess profits—as well as to normal earnings—be retained for the year 1942 and that any increase in rates be deferred until 1943, and that even for 1943 the maximum excess-profits tax rate be not in excess of 80 percent.

After considering the enormous amount of the war expenditures and the small amount represented in total by the loss of revenue for 1 year that would be entailed by this proposal, and realizing the control that the Treasury exercises over the credit market, we are confident that the proposal would not hinder the country's war effort but would give industry opportunity to prepare itself for the financial burden that it would then face in 1943. This deferment in tax-rate increases would

not be inflationary, as the funds would be retained by the corporations by and large in the form of assets other than cash. Should there be, as it is expected there would be, exceptions to this, then it might be well to levy a special 50-percent tax on dividends on common stock paid in 1942 and 1943 in excess of dividends paid in 1941. Such a tax would be payable by the dividend-paying corporation.

Taxes should be collectible on realized profits only.—As previously stated, the present system of levying taxes on income is dangerous to the financial stability of business under present conditions because it is based on "paper" profits rather than cash profits. We recommend that corporations be permitted to defer payment of income and excess-profits taxes at their option, to the extent that the profits on which they are computed are required for investment in working assets or in plant and equipment, not to exceed 50 percent of the total tax, the deferment to continue for a sufficient length of time after the close of the war emergency period to enable the taxpayers to realize cash for such investments.

Provisions for recomputation of the tax liability should be made, in case losses are sustained upon such realization. The following exemplifies the conditions to which our proposal relates, using a corporation with a $400,000 normal tax net income and an excess-profits credit plus the $10,000 specific exemption, amounting to $200,000:

1. Normal tax net income		$400,000
2. Excess-profits and specific credit		200,000
3. Adjusted excess-profits net income		200,000
4. Excess-profits tax at 90 percent	$180,000	
5. Normal and surtax—45 percent of $200,000	90,000	
Total tax		270,000
6. Reinvestment of profits before taxes:		
Increased receivables	$75,000	
Increased inventories	175,000	
Increased plant and equipment	130,000	
(The aforesaid increases are stated after deducting reserves such as for bad debts, replacements, depreciation, allowable for tax purposes.)		
Total increases in assets (reinvestment of profits)		380,000
7. Percentage of profits before taxes, reinvested in business ($180,000÷$400,000)		*Percent* 95

Since 95 percent of the profit of the company was reinvested in the business the company should now, under the limitation proposed, only be called upon to pay 50 percent of the tax in cash immediately, leaving as a liability on its books the balance of 50 percent of the tax payable when and to the extent that the corporation realizes on its increases in the assets aforesaid. As previously stated, this plan should provide for tax recomputation with reduction from prior years' book profits for the losses ultimately realized upon liquidation of the assets in which such prior year-book profits had been invested. We know from the experience with the last war the losses that were taken on receivables and inventories that were taken in 1920 and 1921.

Defects of "tax drawback" bond plan.—Further, as to high tax rates, it has been suggested that there be a drawback in the form of bonds which are nonnegotiable and are subject to other limitations, to be given to companies after the war—allegedly to insure that business will continue after the war. Such a plan would not help business out of its immediate dilemma. Further, any such proposal which would apparently leave much in the way of specific conditions to determination by a future administration now unknown would create doubt and uncertainty where confidence and certainty are needed to maintain sound credit conditions.

Plan for post-war financial rehabilitation of taxpayers.—It is our belief that computation, payment, and receipt of taxes on income have so few points in common with purchase and sale of bonds that no attempt should be made to combine the two. Furthermore, the income tax and excess-profits-tax laws and regulations are now so complex as to defy understanding; addition to the many provisions which are necessary to give equitable treatment, of provisions as to refunds in bonds or sales of bonds, seems unnecessary in the tax laws if rates and collection policies are reasonably established in view of all related conditions, and seems ill-advised and unduly burdensome to all who must deal with the tax laws.

If some reason not now known to us impels Congress to combine provisions for bond sales with tax requirements in the revenue act, then we would recommend that for every 10 percent of adjusted excess-profits net income invested in bonds by the taxpayer there may be a reduction of 5 percentage points in the excess-profits-tax rate with a minimum reduction of 20 percentage points. Such bonds should be of a special type, non-interest-bearing and negotiable, during the war, only to the extent needed to be pledged for collateral or a loan to finance business operations.

Further, it should be stipulated that for a company to get the reduction in tax rate it should not have increased its common-stock dividends in the particular tax year over the rate of dividends it was paying in 1940, such limitation to extend for the duration of the war. The bonds should be redeemable at par at a Federal Reserve bank after the cessation of hostilities in amounts not in excess of 20 percent of the face amounts of the bonds in each year.

Assuming an ultimate maximum excess-profits-tax rate of 80 percent, the foregoing plan would permit the taxpayer to pay out all of his "excess profits" to the Government and yet have 40 percent of such profits available to him in the form of bonds for rehabilitation of business after the war.

This plan would not place an inordinate strain on the Treasury, and with the bonds in hand they should be of great assistance to the taxpaying company in overcoming post-war financial difficulties without the burden of uncertain administrative provisions which might be influenced by political considerations.

Tax deferment for debt reduction.—We understand that the committee is recognizing the need for some alleviation of the impact of taxes where debt obligations are being carried. We recommend that recognition be given in the form of an optional deferred tax on the amount of net income required for such debt payments, the deferred tax to be payable in five annual installments after the war

is over. This recommendation should be limited in its application to debts incurred prior to the year 1942.

Inclusion of intangibles in invested capital.—H. R. 7878 recognizes, in the amendments to the Internal Revenue Code, section 722, the need for relief for corporations filing on an invested-capital basis where intangible assets are essential income producing factors.

The proposed revision would require the use of a reconstructed income in lieu of invested capital. Where the intangibles involved relate to only a moderate percentage of the taxpayer's business serious injustice might be done to a taxpayer by denying it the right to use invested capital in computing the excess-profits credit. It is the opinion of the tax committee of the Brooklyn chamber that section 213 of H. R. 7378 should be revised to permit taxpayers at their option to value intangible income producing assets to be included among the elements now recognized as making up invested capital, where such assets have not been acquired for cash or property.

Capital losses.—H. R. 7878, in the matter of capital losses incurred by corporations, proposes that they be deductible only against offsetting capital gains, and that any excess of losses be deductible only against capital gains that may be realized within 5 years thereafter.

This change levies an undue burden on corporations which have invested their funds in the shares of other companies in many cases to finance war subsidiaries. It is particularly unfair to those companies which have been unable to file consolidated returns in the past because of the change in the law in recent years, thereby being denied the benefit of losses incurred by subsidiaries. Any corrective benefit that might have accrued upon disposal of the stock is now likely to be lost if this denial of deduction of losses is enacted into law.

Deduction for cost of annuity premiums.—H. R. 7378 proposes a marked revision of the deductibility heretofore credited for sums expended for the purchase of annuities. It limits the cost of any annuities that may be purchased in any one year to 5 percent of the annual salary of the employee, plus one-fifth of the amount of the cost that exceeds such 5 percent in each of 5 succeeding years.

Mr. Paul, in his recommendations before the Ways and Means Committee, stated, at page 1005 of the hearings before the Ways and Means Committee on the revenue revision of 1942:

> It is suggested that the employer's contribution should be allowed as a current deduction if the contributions do not exceed 5 percent of the wages and salaries of the employees participating under the plan. Any excess of contributions over such 5 percent shall also be allowed as a current deduction if the employer presents actuarial calculations demonstrating that current contributions in excess of such 5 percent are necessary to discharge the liabilities under the plan. In the absence of such proof the excess shall be deductible in equal amounts over a 5-year period.

Mr. Paul's approach was realistic. The limitation in H. R. 7378 is unrealistic. The 5-percent figure was presumably arrived at by Mr. Paul on the theory that 5 percent of pay roll usually involves a cost equal to the future service benefits under a pension plan. However, he, but not the House bill, was willing to agree to deducting the cost if there was an actuarial basis for it, regardless of whether it was more than 5 percent of the current pay roll.

Five percent in past years may have been sufficient to arrive at a reasonable pension but times have changed. Employee turn-over has been reduced with a consequent lowered withdrawal credit to the employer, interest rates have declined with consequent higher annuity costs, and employers are tending to carry a larger share of the future service cost than heretofore. The result is that the employers' cost for future service benefits under an annuity plan today is usually in excess of 5 percent of the pay roll. If an employer is to institute a plan which reasonably supplements benefits under the old-age section of the Social Security Act, then additional payments must be made to take care of those older employees whose period of employment under the plan will be short that their benefits thereunder would be negligible.

This is commonly called "past service" but is, in reality, the disbursement of annuity premium costs for payment in the future when the employee retires, based on the years of past service up to the time of the start of the plan. Premium payments, therefore, by an employer which are intended to give the employee a retirement sum per year in the future should be deductible in the years the premium payments are made, provided, as Mr. Paul has recommended, that the employer when making the payment divests himself of all right to ownership or control therein and that the amounts of payments conform to the actuarial determination of the moneys required to meet the disbursements to the retiring employees as required under the particular annuity plan.

Further, the bill gives employers until the end of 1942 to make such changes in their existing plans as may be required to have the plans qualify. Since the bill will certainly not be enacted until some time after Labor Day, this gives very little time for the necessary review of the plans, revisions of contracts where group annuity contracts exist, and securing of rulings from the Commissioner of Internal Revenue. From the point of view of the Commissioner alone, his office would be so swamped with requests for rulings, that it would be impossible for it to handle the cases for many months to come. Under these circumstances, the bill should give at least until the middle of 1942—and preferably until the end of 1943—to make the necessary changes for qualifying the existing plans.

The bill provides, as a second requirement, for a plan to qualify under section 165 (a) that the contributions and benefits shall not be discriminatory in favor of the higher paid and supervisory executive employees. Presumably it is intended that social-security benefits will be taken into account in determining whether the formula of benefits is discriminatory.

However, this is not specifically stated in the bill or in the committee report. Clarification could be made by indicating that contributions and benefits shall be combined with practical benefits under the Social Security Act or the Railway Retirement Act for purposes of determining whether they are discriminatory.

In this connection, where social security is taken into account, naturally, the employer buys proportionately more of annuity benefits for the higher-paid employee than he does for the lower-paid employee because of the higher percentage relationship of the social-security benefits to the annuity payment plan for the lower-paid employee.

A plan may be worked out where it is intended that with the combined social security and annuity benefits an employee might receive 40 percent of his salary after a given date.

Consequently, under such an arrangement, the cost of the benefit purchased for a $2,000-a-year employee, as the social-security benefit would be larger percentage-wise when related to the salary of the lower-paid employee at the particular rate indicated.

Tax on long-term capital gains.—H. R. 7378 proposes to increase the tax on long-term capital gains of individuals to a maximum of 25 percent from the present 15 percent. Being well aware of the limits of the capital market of today, we are apprehensive of the effect on corporate development of any further restrictions placed on trading activities. While we do not have any statistics to bear out the point, because the markets have been so adversely affected by war and taxes, nevertheless we are firm in the opinion that an increase in the tax on capital gains of individuals would be a serious deterrent to market operations which are desirable in transfer of investments. The increased tax rate will probably produce little added revenue at best and may actually result in lower revenues.

Section 734 of the Internal Revenue Code relating to inconsistencies.—Notwithstanding all the testimony by numerous organizations and individuals during the hearings on the Revenue Act of 1941 and during the recent hearings before the Ways and Means Committee on the revisions of the Revenue Act of 1942, nothing is proposed in H. R. 7378 either to repeal or to make more clear and certain the effect of section 734 of the Internal Revenue Code, apparently intended to prevent inconsistencies in current tax matters with determinations made in prior years.

The speaker himself has been utterly confounded in the experience of his own company by reason of the variety of opinions received on the subject of what is meant by section 734 and experiences of other taxpayers have been equally perplexing.

We earnestly suggest for your serious consideration the record of the testimony of Mr. Blodgett of Boston, Mass., given before the Ways and Means Committee this past spring, at page 973 of the hearings before that committee on the revenue revision of 1942, and we recommend repeal of section 734, and failing this, we recommend a limitation of its retroactive application to not earlier than 1936.

I understand Mr. Blodgett recently appeared before your committee.

Renegotiation of contracts.—Another and new set of circumstances affecting business engaged in war production has come about as a result of legislation effective April 28, 1942, authorizing the War and Navy Departments and Maritime Commission to renegotiate contract prices.

Heretofore, in appearing before the Senate Finance Committee on tax matters, we have endeavored to enlist its support in the matter of economies in civil expenditures even though the subject was only indirectly concerned with the tax legislation under consideration.

We now ask you to consider the subject of renegotiation of contracts which is more directly related to the tax problem to the end that you will use your best efforts to have the law authorizing renegotiation of contracts repealed.

In asking you this we are being realistic for we all know that the laws today taxing the incomes of corporations and individuals will capture for the Treasury any excess profits which may be realized on war contracts or otherwise. The authority to renegotiate a contract given to the Government departments mentioned simply places another hindrance in the way of production and another psychological handicap for management to overcome in its efforts to do a war job and certainly will make chaotic Treasury attempts to collect war taxes.

If the law allowing renegotiation is not repealed, then H. R. 7378 should be amended to make provision to allow affected corporations to set up reserves out of taxable income to provide for refunds they may be called upon to make as a result of renegotiation of contract prices. Provision should also be made for recomputation of taxes to reflect the necessary readjustments in the reserves after the renegotiations have been concluded.

Pay-as-you-go taxation and withholding tax.—Much has been said during the hearings before the Ways and Means Committee and recently before your own committee on the subject of placing income taxation on a pay-as-you-go basis.

We believe that such a procedure for tax collection purposes could be constructively developed. At present the Government has an amount receivable from an income-tax payer at the end of each year which, as a practical matter, is ordinarily wiped out when the taxpayer, in the year following the taxable year either dies, loses his job, or has his income materially reduced. Objections to a withholding tax could be no longer sustained were taxation placed on a pay-as-you-go basis so that there would not be a doubling, as it were of taxes within a year as would be the case if 1942 taxes were paid in 1942 at a time when withholding was going on against 1943 taxes; if an appropriate ceiling were placed on wages so that the withholding would not tend unduly toward higher wages and disastrous inflation; and if withholding is levied on gross income without deduction—similar to the old-age tax—so as not to place undue burdens upon the withholding agents who are themselves corporate taxpayers already loaded with accounting and reporting burdens which, in any case, are heavy and in some cases heavier than the corporations are able to meet.

War retail sales tax.—The Brooklyn Chamber of Commerce has given a great deal of thought and consideration to proposals to make up in part the deficiency of revenue that is today found as a result of our present revenue laws and as proposed in H. R. 7378 and we find no other suggestion as satisfactory as that which we made to the House Ways and Means Committee last spring and to your committee last year, namely, that a war retail sales tax be enacted.

The need for curbing purchasing power today is clear and urgent. A war retail sales tax will do just that. Further, taxation according to interpretations made of the phrase "ability to pay" has been carried to such lengths that incentive inherent in the successful operation of the enterprise system has virtually been wiped out and there will be scarcely more than a trace of it remaining if the Revenue Act of 1942 is enacted as the House proposes.

Under present conditions there is need of taxation according to ability to spend. If we tax according to ability to spend, which can be done through the war retail sales tax, we pay as we go along and the taxpayer has a substantial degree of control of the spending of the money. Further, a war retail sales tax will reach every segment of our population. The present system of income taxation is unfair and discriminatory in that it reaches only people with determinable incomes. A war retail sales tax would reach everybody including those with incomes not readily determinable such as are found among the agricultural and professional classes of the population.

On the basis of data presented by Mr. Randolph Paul to the House Ways and Means Committee last spring, the Treasury estimated that per table 1, item 4, a war tax of 5 percent on all retail sales of finished articles including industrial and commercial machinery, equipment and supplies, not resold as part of tangible personal property, exempting sales to Federal, State, and local governments and its agencies and to contractors for use in war production, would raise in the neighborhood of $2,500,000,000 and a 10-percent war tax would raise in the neighborhood of $4,600,000,000.

It is recognized that the basis field of retail purchasing is declining as the effects of war production more and more assert themselves on the retail market. It is suggested, therefore, that to the extent that the Treasury estimates are not realized, the war retail sales tax rates be increased.

The Brooklyn Chamber of Commerce is opposed to a manufacturers' sales tax as it is pyramided and its effect is inflationary.

We thank you for this opportunity of expressing our views. We have thus expressed ourselves because we are so strongly impressed by the need of financial policies which will stimulate and not stifle war production; and which will also raise the maximum amounts of revenues which can be raised, currently, without impairment of our business structure and its ability to produce goods and Government revenues, as well as reasonable profits after the war.

(Mr. Hooper submitted the following supplemental suggestions:)

SUPPLEMENT OF SPECIFIC SUGGESTIONS AND ARGUMENT FOR CONSTRUCTIVE CHANGES IN H. R. 7378 AND IN THE TAX LAW AS NOW ON THE STATUTE BOOKS AND IN ITS ADMINISTRATION, SUBMITTED BY THE BROOKLYN CHAMBER OF COMMERCE

[This supplement does not include any of the specific suggestions which are included in the principal report of Brooklyn Chamber of Commerce presented to the Senate Finance Committee August 7, 1942]

CHANGES TO H. R. 7378

1. *Consolidated returns.*—H. R. 7378 extends permission to corporations affiliated one with the other to the extent of 95 percent of stockholdings, to file consolidated returns for normal and surtax purposes if they file consolidated returns for excess-profits tax purposes and comply with certain other requirements. This has been advocated by the Brooklyn Chamber of Commerce for a number of years. However, H. R. 7378 levies a penalty tax of 2 percent of the consolidated corporation surtax net income if a corporation exercises the privilege of filing a consolidated tax returns. The chamber wishes to protest this penalty as being utterly without sound reason, and discriminatory against business units which need to conduct their affairs through more than one corporation. It savors of further attempts to carry out reform measures by means of taxation. We recommend that the 2-percent penalty be deleted from the Revenue Act of 1942.

2. H. R. 7378 changes the basis for assessing taxes on corporations whose fiscal years end on dates other than December 31. The Brooklyn chamber deems the change unnecessary and one which, in the long run, will not be productive of any increase in revenue. Any revenue that the Government might gain by this unwarranted change would be lost at a later date. The change will be burdensome in that it will be retroactive in its effect and will further complicate the tax law as well as the returns of corporations filing on a fiscal year basis. The proposed provision would make difficulty for a corporation desiring to use its natural business year in closing its accounts if that differed from the calendar year and would also tend to prevent a corporation's changing to use of its natural business year for accounting and tax purposes. Use of the natural business year tends to aid in sound and reliable accounting and is accordingly advantageous to business and to the Treasury. We recommend that the provision now in the Internal Revenue Code regarding corporations not on a calendar-year basis be retained.

3. We are opposed to the 5-percent tax on freight that is included in section 621 of the House bill for 1942. This freight charge is bound to have inflationary effect and accordingly should be deleted from the act.

4. The proposed revision of section 722 (a), intended to provide relief in meritorious cases, is seriously weakened by the last sentence, which requires that there be disregarded "events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939." It is recommended that amendment of H. R. 7378 be made to delete this sentence.

5. H. R. 7378, as passed by the House, would require recomputation of the carry-over from a prior year of unused excess-profits tax credit. The computation of the carry-over is complex and difficult at best, and the recomputation is unduly burdensome. The proposed bill should be changed to eliminate any requirement for such recomputation.

CHANGES IN PRESENT REVENUE LAWS

Computation of net income

1. The basis of depreciable assets, for computing gain or loss on sale or exchange or for computing depreciation, should not be reduced on account of depreciation in prior years not used to offset taxable income. The principle is recognized in court decisions and in H. R. 7378 with regard to recovery of bad debts, and it is recommended that it be recognized in the statute by more complete definition in section 113 (b) (1) (A) of the Internal Revenue Code.

2. Corporations should be permitted to carry forward losses until they have been fully recovered from profits instead of for only 2 years. They should also be permitted to carry back subsequent losses against the apparent profits of a period of abnormally high activity like the present. Otherwise the effective rate of tax on income may be higher than is intended or it may result in confiscation of capital. For example, in the case of a corporation which started business on January 1, 1940, and operated for 5 years with aggregate net income in the first 3 years of $1,000,000 and an aggregate net loss in the next 2 years of $800,000, an income tax of 45 percent on annual net incomes, without allowance for losses, would result in taking the entire actual net income for the period and $250,000 of the capital, without any consideration of the possible effect of excess profits taxes.

3. Provision should be made for deduction of general reserves, with reasonable safeguards for protecting Government revenues, in computing taxable net income, with limitations of the period of such deductibility to the current years of high business activity. There should be provision for recomputation and additional tax for the war years if the reserves are found more than necessary for the cost of post-war adjustment and for the costs of both wartime and post-war adjustments in the case of nondefense industries. This provision should be appropriately related to that for carrying back losses, so that subsequent losses, incurred in readjustments, in excess of reserves deducted in years of high activity, can be carried back and taken as deductions. Reserves might properly be limited to a percentage of net income or assets; holding in reserve amounts of tax reduction would also seem an appropriate requirement. Present high tax rates justify, from the Government's standpoint, and make essential, from the standpoint of taxpayers, elasticity in administration of such a provision beyond

that which is practicable under fixed definitions interpreted by the Treasury, which is in the position of an interested party in tax questions and controversies. It is accordingly recommended that provisions be made for boards, reasonably well acquainted with each of the principal industries, to be established to pass upon questions which will arise in application of such a provision to the respective taxpayers.

4. In view of the probabilities of loss years during the post-war readjustment (and of losses during the war period in the case of corporations whose businesses must suffer from wartime readjustments) it is recommended that section 102 of the Internal Revenue Code, intended to prevent undue accumulations of surplus, be liberalized to permit corporate managements to accumulate reserves which they consider proper, without the present jeopardy of penalty surtaxes. At the very least, in view of the uncertainties and obvious difficulties of furnishing proof of future business needs and proof of purposes of holding funds in reserve, section 102 (c) of the Internal Revenue Code should be amended to relieve the taxpayer of the burden of proof and place it upon the Treasury at least until after the end of the war and the subsequent readjustment periods. Reasonably prompt payment of dividends, after the post-war adjustments, should be legally sufficient to relieve a taxpayer of the penalties of section 102, in case subsequent events show that more reserves than are eventually needed have been withheld. The worst that the Government will suffer here will be deferment of receipt of taxes on dividend income. It will in the long run benefit from lower business mortality rates.

From the viewpoint of protection of the Government's revenue in the immediate future, it should be borne in mind that desires of stockholders for dividends are a strong influence against general excessive accumulations of surplus. From the longer view of future revenue and present needs of high production, corporate taxpayers should have reasonable assurance of being permitted to provide reserves so that they need not expect to be facing bankruptcy as soon as war activities end and post-war adjustments start.

5. Taxation of intercorporate dividends should be eliminated. This taxation is one of the inequitable steps in pyramiding of taxes on income from business conducted, due to practical necessity, under corporate form of organization.

6. The Internal Revenue Code should be amended so that the burden of proof would be placed by statute on the Treasury Department where depreciation rates found by the Treasury are below those employed in the taxpayer's regular accounts. If a taxpayer's judgment is faulty and depreciation rates used are too high, this will mean less in net income and tax collections currently but higher income and taxes in later years.

7. The rate of interest on tax deficiencies and refunds should be set at not to exceed 3 percent. The present 6 percent rate is materially out of line with the low interest rates prevailing on debts which are generally well secured. It penalizes unduly the taxpayer required to make additional payments and allows an excessive total amount to the taxpayer who receives refunds for the taxes which he has overpaid.

Excess profits tax

8. The taxpayer using the base period income method for determining the excess profits credit should:

(a) Be allowed to take the average for any three of the four base period years. The year 1938 was in many cases a year of low activity and of losses or very small profits and, therefore, prejudicial in determining fair earnings of a taxpayer.

(b) Be free from the penalty against the use of the earnings method which the law now provides by allowing only 95 percent of the base period earnings to be used in computing the excess-profits credit.

(c) Be permitted to include in computing base period net income any income eliminated from excess-profits net income of the taxable year under section 721 and attributable to a base period year under that section.

(d) Be allowed to pay the tax computed with the benefits of section 722, where that section is applicable, instead of being required to pay the tax without reference to section 722 and then make application for relief.

9. The provisions for computation of excess-profits credit, based on invested capital, are narrow in that they recognize only one of several factors which produce profits. The relation of fair and normal profits to capital requirements varies widely from one industry to another.

One group of factors which may contribute to earnings is that which includes patents, trade marks, formulae, development of processes, etc. These developments are essential to our economic life and improvement of our standard of living. Their fair value may, however, bear little or no relation to the invested capital required to create or acquire them. Earnings from them may be entirely unrelated to wartime activity.

As a matter of fairness to taxpayers now using in their business development factors such as those mentioned, and to avoid discouragement of those who may do future development work, which should be very helpful in alleviating the difficulties of post-war readjustment, it is recommended that provision be made for special allowance under invested capital credit for the fair value of such items as patents, trade marks, formulae, development of processes, etc.

10. For invested capital purposes, the basis for assets should be that used for computing gains rather than for computing losses. The whole matter of excess-profits tax credit based on invested capital relates basically to income and not to losses, and there seems no logical reason for valuing assets as though losses are to be computed.

11. Taxpayers should have the right of using the invested capital agreed upon under the 1917-21 laws as to transactions then taken into account, and then building up thereupon as transactions thereafter have warranted. In the case of older corporations, this would materially simplify the work of taxpayers and of the Treasury in preparing and passing upon returns as well as afford possibility of avoiding extended litigation.

12. Owing to situations confronting many taxpayers, it should be the right of the taxpayer, rather than discretionary with the Commissioner, to use section 723. This section provides, in effect, for taking as the invested capital the net assets at the beginning of the first taxable period rather than going back to the dates of issue of stock, etc.

13. Dividends paid in the first 60 days of a taxable year should not be subject to the present special rule in section 718 (c) (2) of the Internal Revenue Code. There seems no logical reason for saying that dividends paid in 1942, for example, shall be considered to have been paid in 1941.

14. The reduction under section 718 (b) (1) should be for distribution of "earnings and profits" (instead of using the words "accumulated earnings and profits").

15. Carry forward and backward of credit:

(*a*) The unused excess-profits credit carry-over should be extended to not less than 5 years.

(*b*) Provision should be made for carry-backward of unused credits.

16. The daily computation required under the invested capital provisions should be changed to permit of computation of averages on other than a daily basis, without the present limitations. The taxpayer's computations would, of course, be subject to the Commissioner's review and determination.

17. Section 713 (g) (3) which applies where the income method is used, should be amended to recognize borrowed capital added during the taxable year to the same extent as it is recognized in cases where the invested capital method is used.

18. Section 713 (g) should also be amended to recognize that the increase in capital is the amount by which capital for the taxable year exceeds the average of the invested capital for the base period, rather than the actual additions after the end of the base period. For example, the invested capital average might have been $100,000, yet at the end of the base period the invested capital was $150,000 and the addition to capital in the period after the end of the base period was $25,000. Under the law the recognized addition would be $25,000, whereas the suggested amendment would make it $75,000.

19. The law should definitely specify that there is to be included in invested capital appropriate amounts for debts or services for which capital stock has been issued.

20. The normal-growth provisions of section 713 (f) should be extended to determination of average base period net income under supplement A.

21. Emergency excess-profits taxes, surtaxes, and income taxes should be identified as such in the statute and limited by the terms of the legislation enacting them to the duration of the emergency period. The emergency nature of such taxes should be so fully recognized as to eliminate any consideration of their retention permanently in the revenue system where they will stand as deterrents to the national economic development and progress in peacetimes.

22. In the interest of efficiency, it is recommended that corporations whose rates, and, consequently, whose gross and net incomes, are regulated by Federal and State government agencies, should be exempt from excess-profits taxes.

23. Income and excess-profits taxes should only be applied to reduce invested capital if and when paid, and not, as under present regulations, when the liability accrues as of the end of a taxable year.

24. With reference to our recommendation that the present tax rates be continued with respect to income for the year 1942, the sliding scale of excess-profits tax rates should be made applicable to percentages of the excess-profits tax credit rather than fixed amounts of excess profits.

25. Further, in the determination of profits subject to excess-profits taxes, the normal and surtaxes should be deducted from the normal tax net income and the balance, after deducting the excess-profits tax credit, should be subject to excess-profits tax rates, following out the procedure set forth in the Second Revenue Act of 1940.

26. As stated in previous presentations to your committee, the rates applied to invested capital for purposes of computing the excess-profits credit are inadequate to provide reasonable incentive to investors. H. R. 7378 proposes even lower rates than those now in effect. At the very least, the rates now in effect should be continued; and they should be increased for the benefit of war production and for protection of our business structure.

General

27. Amendment should be made to the Internal Revenue Code to permit of the deduction in the year paid of additional wages expended as a result of rulings under the Wages and Hours Act, for services relating to prior years, or else a taxpayer should have the opportunity of reopening his tax returns for the years affected by the adjusted wage payment.

28. In view of the complexity of the present income and excess-profits-tax laws, the multiplicity of voluminous reports and returns which corporate taxpayers are now required to prepare and file, and the serious shortages of personnel having the training and aptitude necessary for the preparation of such reports, it is recommended that corporate taxpayers be permitted to file their income and excess-profits tax returns at any time within 5½ months after the close of the year for which the returns are prepared, with the understanding that within 2½ months after the close of the year the taxpayers shall be required to file returns of estimated income and tax, and to pay one-fourth of the tax so estimated.

The CHAIRMAN. Mr. Dyett.

STATEMENT OF A. D. R. FRASER, ROME, N. Y., REPRESENTING ROME CABLE CORPORATION

Mr. FRASER. I am appearing instead of Mr. Dyett.

The CHAIRMAN. Is Mr. Collins associated with you?

Mr. FRASER. Mr. Chairman, my name is A. D. R. Fraser. I am appearing both for Mr. Dyett and for Mr. Collins, of our company.

Senator CONNALLY. Mr. Chairman, may I make a general suggestion to the witnesses?

The CHAIRMAN. Yes, sir.

Senator CONNALLY. If they file their statement and then just take out the material points mentioned in their statement, it would make a much better impression on the committee, rather than giving us a long-winded sermon.

Mr. FRASER. Mr. Chairman, my statement is approximately 10 minutes long, and I think I can crowd it into that space. I would like to complete it, with your permission.

The CHAIRMAN. Yes, sir.

Mr. FRASER. My name is A. D. Fraser. I am secretary and a director of the Rome Cable Corporation, Rome, N. Y., a company founded and incorporated in 1936 under the laws of the State of New York.

Mr. V. W. Collins, who is assistant treasurer, comptroller, and a director of our company, who assisted in the preparation of this brief, is here with me.

Our company appreciates the privilege extended to us of appearing before your committee to present certain facts for your consideration, indicating how the revenue act as passed by the House would seriously curtail our operations as well as those of many other companies in similar circumstances.

Our company is a comparatively new one. It was started as a new venture in 1936 by a few experienced men formerly connected with the electrical wire and cable industry, with confidence and trust in our system of free enterprise.

We manufacture a broad line of electrical wires and cables, rolling rods from copper bars and further fabricating to the finished product, bare and insulated wires and cables.

Insofar as certain critical materials have been available, we have operated on a three-shift basis wholly on war work for many months. Our products go direct to the Army, Navy, Maritime Commission, to our Allies in all parts of the world, to the building of plants, camps, for the weapons and armaments of war, to electrical manufacturers, and the various utility services.

We organized on a very low initial investment basis of $1,750,000 paid in capital, all in common stock, by approximately 800 stockholders of which 69 are employees.

Due to the low invested capital, we, of necessity, use the average income basis for determination of excess profits subject to tax. The designated base period, 1936–39 is the period of our start and growth and even under present regulations we have been and are seriously penalized due to this.

Without taking up unnecessary time with details, briefly, the growth of our company is indicated by the increase in sales from $836,000 in 1936 to over $12,000,000 in 1941, an increase of over 14 times the 1936 level. Our employees increased from 257 in the productive period of 1936 to 713 at present, with an annual pay roll of approximately $2,000,000. Employee average hours taken for the entire period have averaged well over 40 hours per week. We are paying wages on a parity with other local manufacturers and also with manufacturers in the same industry. In addition, the company instituted of its own accord an employee dividend-sharing plan in 1939 at the same time it started payments of dividends to stockholders.

Early in our career it was evident that our low capital investment was insufficient to finance the ever increasing volume of business with its attendant inventory, receivables and pay roll increases, so that heavy bank loans were usually necessary. Late in 1940 we negotiated for an $800,000 7-year long-term loan requiring fixed yearly amortization.

The need for further money to meet increased volume was offset by efficient mass production methods, multi-shift operations, rapid turn-over of inventories and receivables. Illustrative of this, the May 1942 figures on inventories and shipments as published by the Department of Commerce show a 71-percent increase in inventory over 1939 for all industry, whereas our inventories increased only 12 percent, while shipments in both instances were up about 100 percent.

Although increased taxes have eaten heavily into our profits, by the above means we have maintained a fair earnings ratio of 7 percent on sales before taxes and 3.9 percent after taxes for the 6-year period ended March 31, 1942. As an actual matter of fact, total taxes paid or accrued in this period exceeded net earnings. We do not believe that this 3.9 percent return on sales can be construed as profiteering in the war effort.

It is worthy of note, however, that in the quarter just closed June 30 that, while sales were at the same average level as last year, operating costs have increased 20 percent, due to increased cost of raw materials, two voluntary labor rate increases and increased operating costs due to lack of critical materials for planned quantity runs. On the other hand, our sales prices have been pegged by price ceiling. In other words, with sales at the same level as last year we find a drop in earnings before taxes of approximately 20 percent or over $300,000 on a yearly basis. On the House tax bill our net profit on sales drops to 2.1 percent, which is inadequate to provide for the expansion program already undertaken, debt amortization, a modest dividend of 15 cents per share quarterly, setting up any reserve for wartime operation contingencies, not to mention impossibility of any provision being made for post-war adjustment to plant, equipment, and the continued employment of labor.

The above remarks have been made to demonstrate that from our start we have been penalized as a growth company by the constant rising tide of taxation. We recognize the tremendous increase in the cost of an all-out war. Like all American industry we stand ready and willing to do our financial share as we are doing our production share, but we cannot help but be alarmed at the penalization of our productive and management effort, and the weakening of financial structure which the tax bill in its present form portends.

Because of an expansion of production facilities involving an expenditure of almost $300,000 of our own money this year, which we were asked to undertake by the military authorities; because of the possibility of retroactive tax assessment on fiscal year companies, which would cost us $69,000; because of regular long-term debt amortization of $160,000 per year, while only maintaining our modest annual dividend payment of $114,000, or 15 cents per share per quarter, and without figuring any reserve to provide for contingencies or for further expansion of our war production effort or to provide for increased inventories or receivables for the expansion already in progress, we face a drop of cash of over $200,000 during the current year and the necessity of borrowing very substantial amounts to pay our taxes next year.

For our computations we have estimated earnings before taxes for the current year at $1,250,000 compared with over $1,500,000 last

year. Under the present 1941 law our tax burden would be $730,000, or 58 percent of taxable income, or net income of 3.8 percent on sales. Under the House bill, tax would increase to $967,000 or over 77 percent of income with only a 2.1 percent net income on sales.

We heartily endorse certain relief provisions in the present bill.

Senator BROWN. Mr. Fraser, I am interested in what you say about the taxes and the earnings. In the National City Bank letter for this month the figures for 290 leading corporations in the United States who have made their reports for the first 6 months of this year, and applying the rates in the House bill to their income, show an average of 73 percent after all taxes. That is very close to your figure.

Mr. FRASER. Yes. Our figure is 77 percent. .

Senator BROWN. Compared with 52 percent in 1941.

Mr. FRASER. Ours was 58.

Senator BROWN. And 47 percent in 1940.

Mr. FRASER. Yes.

Senator BROWN. I think that very well bears out what you say about the effect of the tax bill on your company.

I might suggest, Mr. Chairman, that I would like to have printed in the record, right after the statement of this witness, the three or four paragraphs in the August letter of the National City Bank, giving a very good factual statement of the results of the first half year of this year on those 290 corporations, together with a table showing the falling off in the net income for these corporations. I think it would be valuable to the committee in their consideration of this matter.

The CHAIRMAN. Yes; that may go into the record following the witness' statement.

Mr. FRASER. May I continue, sir?

The CHAIRMAN. Yes.

Mr. FRASER. Possibly our only hope of relief comes in section 213 of the current House bill in subsection 4 covering companies commencing business and changing character of business during the base period. We have read and reread this section and we find a far from definite formula is planned and the uncertainty and delay involved is unfortunate when time devoted to productive effort is so essential. This uncertainty and delay, plus required payment of two-thirds of tax, pending decision from the court of relief, does not encourage prompt decisions that are so necessary today, since an unfavorable decision from the court might well endanger the very existence of a company.

In our own case we feel a fair basis would be to consider the fiscal years 1938–41 as our base years—1936–37 being distinctly starting years with us—but our feeling does not necessarily insure our getting it from the court of relief. If we could use the years 1938–41 as our constructive base period, our tax would amount to $858,000 and leave a profit of 2.9 percent on net sales.

We rather like a plan brought to our attention by the Norris Stamping & Manufacturing Co. of Los Angeles, Calif., which presents a definite formula of relief. I understand you had that presented to you.

The CHAIRMAN. Mr. Norris appeared yesterday.

Mr. FRASER. Time does not permit a detailed discussion of this plan but it is contained in an exhibit submitted as part of this brief. With the permission of that company, briefly the formula which recognizes the pyramiding of sales in the current situation would mean an adjustment of excess-profits-tax credit somewhat as follows:

For the first 100-percent increase in sales for the base period, the excess-profits tax credit is to be increased 50 percent.

The second 100-percent increase in sales, the credit is to be increased an additional 33⅓ percent.

For each additional 100-percent increase in sales, the credit is to be increased an additional 25 percent.

In our case with a 180-percent increase in sales over the base period, our excess-profits-tax credit would be increased 76⅔ percent. Our taxes under this plan would represent 68 percent of earnings with a profit of 2.9 percent on net sales, instead of taxes of 77 percent and earnings of 2.1 percent under the House bill. This plan recognizes that the major portion of earnings must be paid in the form of taxes, but also recognizes that some reasonable amount must be retained by the corporation.

We are a fiscal-year company. Starting production in mid 1936, we decided to run to March 1937 to give us a better productive period, and even considered June as our year end, in view of the fact that the Government operates on a June fiscal year. Ours is not a seasonal business, so there is no natural business year. We can see justification in the desire to have all companies assessed for taxes on a calendar-year basis, but we plead with you that the clause not be made retroactive for the year 1942. Seven months have already gone by, possibly several more before the 1942 Revenue Act will be in definitive form. Would we as directors in January 1942, faced with an expansion program for the war effort, have voted almost $300,000 to finance that program? Could we reasonably have declared even our modest dividend had we known of the additional tax expense that would be assessed upon us some 8 or 9 months hence? The necessity for making important speedy decisions today should not be hampered by possible penalization of retroactive tax assessments. The cost of this additional assessment to us would entirely wipe out our earning for the first quarter of our fiscal year 1942. In our case, as in many others, this is a severe and unjust penalty without having an opportunity to plan accordingly. We recommend therefore that this provision of the House bill either be deleted or made effective as of the beginning of a fiscal year starting in 1942. Thereafter these companies would be subjected to any changes on a calendar-year basis.

We agree with certain publicized opinions expressed by members of your committee that some formula for debt amortization is not only desirable and economically sound, but an excellent guard against inflation. This will protect the stability of companies, as well as individuals, for that period of post-war readjustment when financial stability will be so vital to the welfare of the world.

Before closing, may we also bespeak our endorsement of a lower normal and surtax rate than the 45-percent rate proposed in the House

bill. Even a 40-percent rate may work hardship on many companies.

In view of the time limitation we have only briefly touched on the effect of the House bill on our earnings and the modifications suggested in this paper, but they are submitted in detail in attached schedules with this statement, which we are leaving for your committee.

Again we thank you for the opportunity you have given us today. We fully appreciate the need for increased taxation and a perusal of previous hearings makes us realize the problem you are facing in endeavoring to equitably arrive at the solution of this gigantic problem. We realize the necessity of writing a law that will produce greatly increased revenue, but we do not believe that you wish to write a law that will cripple or put out of existence many companies. For that reason we respectfully request your fair consideration of the points advanced by us here today, namely:

(1) A more definite formula for relief provisions;
(2) No retroactive assessment on fiscal year companies at this time;
(3) Some form of debt-amortization credit; and
(4) A lower normal and surtax rate rather than 45 percent.

Thank you very much, gentlemen.

(Mr. Fraser submitted the following schedules:)

ROME CABLE CORPORATION, ROME, N. Y.

SCHEDULE 1.—*Schedule of normal and excess-profits taxes—Net income based on estimated sales and taxable income for the fiscal year ending Mar. 31, 1943, under the Revenue Act of 1941*

Net sales	$13,500,000
Taxable income	1,250,000
Excess-profit credit, including specific credit	344,699
Profit subject to excess-profits tax	905,301
Profit subject to normal and surtax	752,820
Excess-profits tax	497,180
Normal and surtax	233,124
Total normal, surtax, and excess-profits tax	730,304
Percentage of tax to taxable income	58.4
Net income after tax	$519,696
Percentage of net income to net sales	3.85

ESTIMATED EFFECT OF ABOVE INCOME ON CASH POSITION FOR YEAR ENDING MAR. 31, 1943

Taxable income plus $120,000 depreciation	$1,370,000
Less expenditures for tax liability, payments on serial notes, possible retroactive tax assessment (fiscal-year provision), dividends, and commitments for capital expenditures, a total of	[1] 1,345,676
Leaving cash available	24,324

[1] Does not include any provision for increasing inventories, receivables, nor any addition to surplus to provide for actual war-operation contingencies, post-war years rehabilitation of plant, equipment, etc., and continued employment of labor.

SCHEDULE 2.—*Schedule of normal and excess-profits taxes—Net income based on estimated sales and taxable income for the fiscal year ending March 31, 1943, under the proposed House bill of July 21, 1942*

Net sales	$13,500,000
Taxable income	1,250,000
Excess-profits credit, including specific credit	349,699
Profit subject to excess-profits tax	900,301
Profit subject to normal and surtax	349,699
Normal and surtax	157,365
Excess-profits tax	810,271
Total normal, surtax, and excess-profits tax	967,636
Percentage of tax to taxable income	77.4
Net income after tax	$282,364
Percentage of net income to net sales	2.09

ESTIMATED EFFECT OF ABOVE INCOME ON CASH POSITION FOR YEAR ENDING MAR. 31, 1943

Taxable income plus $120,000 depreciation	$1,370,000
Less expenditures for tax liability, payments on serial notes, possible retroactive tax assessment (fiscal year provision), dividends, and commitments for capital expenditures, a total of	[1] 1,583,008
Cash deficit	*213,008*

[1] Does not include any provision for increasing inventories, receivables, nor any addition to surplus to provide for actual war operation contingencies, post-war years rehabilitation of plant, equipment, etc., and continued employment of labor.

SCHEDULE 3.—*Schedule of normal and excess-profits taxes—Net income based on estimated sales and taxable income for the fiscal year ending Mar. 31, 1943, under the proposed relief provision of the House bill. Constructive base period net income assumed to be average of earnings for 1938–41, inclusive*

Net sales	$13,500,000
Taxable income	1,250,000
Excess-profits credit, including specific credit	684,200
Profit subject to excess-profits tax	565,800
Profit subject to normal and surtax	684,200
Normal and surtax	307,890
Excess profits tax	509,220
Five percent of excess-profits tax computed without reference to relief provision	40,514
Total normal surtax and excess-profits tax	857,624
Percentage of tax to taxable income	68.6
Net income after tax	$392,376
Percentage of net income to net sales	2.91

ESTIMATED EFFECT OF ABOVE INCOME ON CASH POSITION FOR YEAR ENDING MAR. 31, 1943

Taxable income plus $120,000 depreciation	$1,370,000
Less expenditures for tax liability, payments on serial notes, possible retroactive tax assessment (fiscal year provision), dividends, and commitments for capital expenditures, a total of	[1] 1,472,996
Cash deficit	*102,996*

[1] Does not include any provision for increasing inventories, receivables, nor any addition to surplus to provide for actual war-operation contingencies, post-war years rehabilitation of plant, equipment, etc., and continued employment of labor.

SCHEDULE 5.—*Schedule of normal and excess profits taxes—Net income based on estimated sales and taxable income for the fiscal year ending Mar. 31, 1943, under the Norris Stamping and Manufacturing Co. proposal for growth companies*

Net sales	$13,500,000
Taxable income	1,250,000
Excess-profit credit, including specific credit	610,135
Profit subject to excess-profits tax	639,865
Profit subject to normal and surtax	610,135
Normal and surtax	274,561
Excess-profits tax	575,879
Total normal, surtax, and excess-profits tax	850,440
Percentage of tax to taxable income	68.0
Net income after tax	$399,560
Percentage of net income to net sales	2.96

ESTIMATED EFFECT OF ABOVE INCOME ON CASH POSITION FOR YEAR ENDING MAR. 31, 1943

Taxable income plus $120,000 depreciation	$1,370,000
Less expenditures for tax liability, payments on serial notes possible retroactive tax-assessment (fiscal year provision) dividends, and commitments for capital expenditures, a total of	[1] 1,465,812
Cash deficit	*95,812*

[1] Does not include any provision for increasing inventories, receivables, nor any addition to surplus to provide for actual war-operation contingencies, post-war years rehabilitation of plant, equipment, etc., and continued employment of labor.

SCHEDULE 6.—*Additional tax for fiscal year ended Mar. 31, 1942 which the company would be required to pay on the basis of the House bill*

Taxable income, fiscal year ended Mar. 31, 1942	$1,508,084
Excess-profit credit including specific credit	349,699
Profit subject to excess-profits tax	1,158,385
Profit subject to normal and surtax	349,699
Normal and surtax	157,365
Excess-profits tax	1,042,547
Total normal surtax and excess-profits tax based on rates in proposed House bill	1,199,912
Percent to taxable income	80.0
Total tax payable under Revenue Act of 1941, $917,157 × 75 percent (9 months)	$687,868
Total tax based on proposed rates $1,199,912×25 percent (3 months)	298,228
Amended tax for fiscal year ended Mar. 31, 1942, based on fiscal year provision in proposed bill	986,096
Total tax payable under Revenue Act of 1941	917,157
Additional tax for fiscal year ended Mar. 31, 1942	68,939

SCHEDULE 7

NORRIS STAMPING & MANUFACTURING CO.

EXHIBIT A.—*Adjusted excess-profits tax credit—Determined by adding a percentage of base-period credit for each 100-percent increase in volume of sales over base-period sales*

	Percentage of base period credit	Percentage of excess-profits tax credit (adjusted)	Amount of excess-profits tax credit (adjusted)[1]
Volume of sales to base period sales:			
100 percent	100	100	$475,000
200 percent, add	50	150	712,500
300 percent, add	33⅓	183⅓	870,833
400 percent, add	25	208⅓	989,583
500 percent, add	25	233⅓	1,108,333
600 percent, add	25	258⅓	1,227,083
700 percent, add	25	283⅓	1,345,833
800 percent, add	25	308⅓	1,464,583
900 percent, add	25	333⅓	1,583,333
1,000 percent, add	25	358⅓	1,702,083
2,000 percent, add	25	608⅓	2,889,583
4,000 percent, add	25	1,108⅓	5,264,583

[1] Plus $10,000 specific credit.

NOTE.—Based on corporation with $5,000,000 base period sales and profit of 10 percent, equalling $500,000 base period credit.

NOTE.—The above is a copy of an exhibit prepared by Norris Stamping & Manufacturing Co.

SCHEDULE 8.—*Net sales, earnings before taxes, income taxes, net income, total taxes paid, and number of employees*

	Fiscal year	Net sales	Earnings before taxes	Percent to net sales	Federal income taxes	Percent net sales	Net income	Percent net sales	Total, all taxes paid or accrued	Number of employees
Year ending—										
Mar. 31, 1937	1936	$1,951,000	$2,000	0.1			$2,000	0.1	$17,000	257
Mar. 31, 1938	1937	5,226,000	105,000	2.0	$34,000	0.7	71,000	1.4	63,000	326
Mar. 31, 1939	1938	5,816,000	301,000	5.4	57,000	1.0	244,000	4.3	97,000	394
Mar. 31, 1940	1939	6,425,000	365,000	5.7	67,000	1.0	298,000	4.6	123,000	540
Mar. 31, 1941	1940	9,899,000	667,000	6.7	242,000	2.4	425,000	4.3	323,000	602
Mar. 31, 1942	1941	13,407,000	1,527,000	11.4	926,000	6.9	601,000	4.5	1,061,000	713
Total, 6-year period		42,524,000	2,967,000	7.0	1,326,000	3.1	1,641,000	3.9	1,684,000	.....
Apr. 1-June 30, 1942	1942	3,009,000	285,000	9.5	219,000	7.3	66,000	2.2	252,000	.....

(The excerpt from the National City Bank letter (August 1942), referred to by Senator Brown is as follows:)

[From August 1942 letter of National City Bank, New York, N. Y.]

THE HALF YEAR'S EARNINGS

The decline in corporation earnings which appeared in the first quarter of this year continued in the second quarter; and the half year's earnings of industrial companies which have reported during the past month show, in a great majority of cases, a considerable decrease in net income, compared with a year ago. Sales as a rule were substantially larger, but operating expenses were higher and taxes took a greatly increased percentage of income.

A tabulation of the statements of 290 companies in the major manufacturing, mining, trade, and service industries shows for the first half of 1942 combined net income of approximately $475,000,000 after taxes, which compares with $725,000,000 for the same companies in the first half of 1941—a decrease of 35 percent.

This group of companies, representative for the most part of the larger organizations, employed an aggregate capital and surplus of approximately $12,600,000,000 at the beginning of the year.

Reserves for Federal income and excess-profits taxes reported by 155 of the manufacturing companies were up sharply from last year because of the steep increase in rates proposed in the pending revenue bill, which almost all of the companies used as a basis for their computations. For this group giving tax details, the estimated tax liability for the first half year 1942 amounted to $884,000,000, compared with $578,000,000 in the corresponding period of 1941, and $163,000,000 in 1940. Such taxes absorbed 73 percent of the net income before taxes this year, compared 52 percent in 1941 and 27 percent in 1940.

The portion of industrial corporation income being taken by Federal taxes is now far above that ever reached in the past. During the last war, Federal taxes absorbed only about 23 percent of the net income of all manufacturing corporations in 1917, 45 percent in 1918, and 26 percent in 1919.

Separate quarterly figures available for 252 of the industrial companies indicate that net income after taxes in the first quarter of 1942 was 29 percent below that of the first quarter 1941, while the second quarter 1942 was 41 percent below the second quarter 1941. One of the principal reasons for the greater drop was the fact that second quarter earnings this year in many cases were burdened with charges for additional tax reserves covering the first quarter. These additional reserves were necessitated by the fact that the provision originally made is now found inadequate in view of the revenue bill as recently passed by the House.

The pending rates of 90 percent on excess profits above the base as defined, plus 45 percent combined normal and surtax, compare with maximum rates of 87½ and 45 percent, respectively, when the bill was reported to the House, and with 94 percent (including 14 percent post-war credit) and 40 percent originally decided on in the House Ways and Means Committee. The corresponding rates effective in 1941 were 60 and 31 percent, in 1940 were 50 and 24 percent, and in 1939 there was an 18-percent normal tax only.

Net income of leading corporations for the half year—Net income is shown after depreciation, interest, taxes, and other charges and reserves, but before dividends—Net worth includes book value of outstanding preferred and common stock and surplus account at beginning of each year

[In thousands of dollars]

No.	Industrial groups	Net income, half year		Per cent change	Net worth, Jan. 1		Annual rate of return (percent)	
		1941	1942		1941	1942	1941	1942
4	Baking	$6,197	$6,240	+0.7	$187,742	$182,264	6.6	6.8
18	Other food and beverage	39,212	30,653	−21.8	576,462	583,143	13.6	10.6
15	Textiles and apparel	12,327	8,669	−29.7	182,033	196,704	13.5	8.8
13	Paper products	7,134	6,564	−8.0	175,275	181,616	8.1	7.2
22	Chemicals, drugs, etc	93,342	67,035	−28.2	1,349,393	1,423,458	13.8	9.4
9	Petroleum products	106,573	64,739	−39.3	2,202,176	2,224,059	9.7	5.8
8	Stone, clay, and glass	12,370	5,099	−58.8	193,468	189,503	12.8	5.4
26	Iron and steel	145,274	86,233	−40.6	2,968,108	3,093,872	9.8	5.6
8	Building equipment	7,669	6,055	−21.0	185,330	186,612	8.3	6.5
10	Electrical equipment	43,514	32,022	−26.4	572,330	632,045	15.2	10.1
22	Machinery	19,624	16,401	−16.4	269,528	293,077	14.6	11.2
7	Office equipment	12,215	9,124	−25.3	156,221	162,383	15.6	11.2
7	Automobiles	124,574	51,146	−58.9	1,177,340	1,210,647	21.2	8.4
14	Auto equipment	11,753	10,178	−13.4	114,590	128,462	20.5	15.8
9	Railway equipment	10,619	8,062	−24.1	176,848	190,221	12.0	8.5
24	Metal products—miscellaneous	16,404	13,434	−18.1	261,489	276,457	12.5	9.7
23	Miscellaneous manufacturing	19,625	14,245	−27.4	403,509	422,118	9.7	6.7
242	Total manufacturing	688,526	436,099	−36.7	11,149,842	11,576,636	12.4	7.5
11	Coal mining	[1] 2,735	[1] 4,110	+50.3	212,266	217,842	2.6	3.8
6	Metal mining	[1] 7,648	[1] 9,093	+18.8	162,445	161,501	9.4	11.3
10	Mining, quarrying—miscellaneous	[1] 10,855	[1] 11,139	+2.6	172,786	181,096	12.6	12.3
14	Trade (wholesale and retail)	8,197	6,918	−15.6	269,899	270,306	6.1	5.1
7	Service and construction	7,290	7,224	−.9	214,459	219,433	6.8	6.6
290	Total	725,251	474,583	−34.6	12,181,717	12,626,514	11.9	7.5

[1] Before certain charges.

The CHAIRMAN. Mr. Schram.

STATEMENT OF EMIL SCHRAM, PRESIDENT, THE NEW YORK STOCK EXCHANGE, NEW YORK, N. Y.

Mr. SCHRAM. My name is Emil Schram. My address is 11 Wall Street, New York—president of the New York Stock Exchange.

I appreciate very much the committee's courtesy in allowing me the time for a brief discussion of certain aspects of the capital-gains tax. What I have to say will deal chiefly with the general philosophy of this tax, as I see it. You doubtless have already heard or will hear from others a technical discussion of the questions involved and you are familiar, I am sure, with the very extensive testimony that was presented before the House Ways and Means Committee on the same subject.

In the course of a long and careful study of the capital-gains tax, I have talked with a wide range of people—tax experts, practical businessmen, farmers, representatives of organized labor, and many others. I have been impressed by the widespread desire that this particular feature of our tax laws be revised. I think all of them agree on the one fundamental point; namely, that the Government would derive much-needed additional revenue from a realistic revision.

The conduct of this war requires such tremendous sums of money that it would be pointless for me to advocate a modification of the capital-gains tax unless I were convinced that it would provide greater revenue to the Treasury. It is my conviction that the Treasury's revenue would be greatly increased if the capital-gains tax provisions were modified in such a way as to eliminate the holding period and to establish a tax rate that would encourage the taking of capital gains, thus tapping a very large potential source of revenue.

Because revenue is the paramount consideration at this time, I realize that any discussion of the unsoundness of the capital-gains-tax principle is more or less academic.

However, it has always been perfectly obvious that the sale or exchange of a capital asset, such as a piece of real estate, a farm, a share of stock, or a bond, does not automatically add anything to the value of the thing sold. From an economic point of view, the gain resulting from such a sale or exchange is in reality capital, and not income. For bookkeeping purposes—and, in fact, for all other purposes except taxation—such a gain is regarded as representing capital. Hence, a capital-gains tax is in reality a capital levy.

In view of the fact that the taking of a capital gain is purely discretionary with the taxpayer, it is apparent that this tax in operation is far different from a true income tax. The payment of the tax is entirely contingent upon the taxpayer's disposing of a capital asset at a profit. It is not surprising, therefore, that as the rate of the capital-gains tax has been increased, the net revenue to the Government has decreased.

Thus, when the capital-gains tax was raised to a point where it discouraged transfers it defeated its own purpose as a revenue-producing measure. Experience has indicated that the amount of the tax revenue is in inverse proportion to the tax rate. The inescapable conclusion is that the best way to produce the most revenue from

a capital-gains tax is to make the rate low enough so that the tax will not deter the taxpayer from transferring his property. The urgent need of additional revenue to help meet the cost of the war would seem to make such a legislative amendment imperative at this time, particularly in view of the many other sound reasons which have been advanced.

Apart from considerations of revenue, there are certain undesirable economic consequences which would arise out of an unproductive tax. Because such a tax would operate, as I have said, as a serious deterrent to the transfer of property, it would retard the general flow of capital. The particular point which I wish to make is that in our effort to obtain additional revenue we should not impose a penalty that would make venture capital impotent. We should not deprive investors of the freedom needed to make necessary shifts in their holdings in order to keep them current. There is particular need of this freedom at this time in order that the purchase of Government bonds may be facilitated.

This problem of the fluidity of capital is important in another sense. While it is true, as the Treasury has pointed out, that the major portion of the financing required by American industry in its war expansion is being assumed by the Government, it is desirable that as large a portion as possible of the burden be borne by private capital. It is not too soon to begin the process of encouraging capital to perform its traditional function, particularly in preparation for the post-war readjustment.

Of course, there are many technical objections to the present capital-gains tax—for example, objections directed toward the artificial and unsound distinction between long-term and short-term gains which underlies the present law. It is my considered judgment that this is the most objectionable feature of the law. The Treasury objects to a shorter holding period on the ground that it would give special tax advantage to gains realized from speculative activity. As a matter of fact, there is very little speculative activity today, and I do not anticipate that the changes which we are advocating will bring about any substantial increase in such activity. Let me add, however, that speculation by informed people who can afford to take risks will always be a constructive influence in our form of economy.

We would expect, of course, that the liberated flow of capital would be reflected in a better investment market—a market freed from artificial deterrents and restraints such as those which stem from the present tax—but I would not be here asking for a revision of this tax if I were not convinced that the welfare of our whole business system was involved.

Another aspect of this question which needs to be emphasized is that the capital-gains tax, as now applied, tends to prevent a powerful anti-inflationary influence from coming into play. The mischievous effect of the tax in this respect was demonstrated in the boom of the late 1920's. Its potentiality for harm is even greater today in view of the many existing factors which are supplying the foundation for inflation.

The capital-gains tax, if the deterrents to the transfer of property were removed, would be paid by those who could afford to pay it.

It would not fall upon the poor. The statistical record shows plainly that high rates of tax on capital gains merely restrict or prevent entirely the transfer of capital assets. An examination of the yield from this tax in recent years will convince any reasonable person of this fact. I understand that the 1941 results, which I am sure the Treasury has available or can compute, were the most disappointing since the principle of taxing capital gains was introduced. In the light of the record, I do not see how the provisions of the present law can be justified.

Let me say here that the Treasury, in the course of the hearings before the Ways and Means Committee, presented some constructive proposals looking to the revision of these provisions. It is gratifying that the Ways and Means Committee saw fit to adopt some of these proposals. I submit, however, that a thoroughgoing and realistic readjustment is urgently needed and that it will contribute greatly toward the accomplishment of the objectives which we all know are dominating congressional thought—more tax revenue for the prosecution of the war, restraint upon inflationary tendencies, and the healthy functioning of our enterprise system.

The CHAIRMAN. Are there any questions?

Senator VANDENBERG. Mr. Chairman, may I ask Mr. Schram a question?

The CHAIRMAN. Yes, Senator.

Senator VANDENBERG. Departing somewhat from your immediate objective, but based on your statement, on page 3, "because such a tax would operate as a serious deterrent to the transfer of property, it would retard the general flow of capital"; that is equally true of the war debt, is it not? I ask you this question because you are a banker of large experience. You were formerly head of the Reconstruction Finance Corporation. What particularly I would like your comment on is this: In your judgment, is it safe to rely upon voluntary bond purchases, which will not exceed $12,000,000,000 a year, and rely on bank purchases for $30,000,000,000 of the final bond sales necessary to finance this year's war operations?

Mr. SCHRAM. Perhaps you can finance this year's operations by voluntary purchases, but I doubt whether it can be done by this method until the end of the war.

Senator VANDENBERG. The forcing of $30,000,000,000 of bonds into the banks has a definite inflationary tendency, does it not?

Mr. SCHRAM. I think it does; yes.

Senator VANDENBERG. That is all.

Senator CONNALLY. What is your proposal, Mr. Schram, as to the time? Because there is a distinction between short-time and long-time gains.

Mr. SCHRAM. I recommend the elimination of the holding period, Senator, because I think the amount of money you want to raise, that you might be able to raise, is determined almost entirely by the holding period.

Senator CONNALLY. Would you be satisfied with the clause that the gains could be offset with losses over the same period?

Mr. SCHRAM. Again, I think the present provision that permits the deduction of losses from long-term gains from ordinary income

reduces revenue considerably. I think that the proposal to limit the deduction of capital losses only against capital gains is a sound one, in view of the fact that you need to raise more revenue. I think it is unfair, though, Senator, in the treatment of short-term gains, to tax them as income but still not give credit for losses. That is hardly fair to the taxpayer. As we have said a good many times, the Treasury has its cake and eats it, too.

The CHAIRMAN. Mr. Schram, as I understand you, you regard the holding period as more important than the rate imposed under the House bill?

Mr. SCHRAM. Yes; I do, Senator. I think the holding period is the important feature. It should be the most important factor in considering any chances that may be made.

Senator TAFT. Mr. Schram, the objection has been made that to eliminate any holding period, putting all income on the basis, a man can go and make a living practically by speculating in stocks without there being any income tax but paying only the other taxes. How do you meet that objection?

Mr. SCHRAM. Senator, that is, of course, the purpose that has really been the basis for the holding period—that is, to try to discriminate against that particular man who makes his living that way. I will agree that if a man makes a living in the business, that is his business, I think possibly he should pay the same tax as anybody else pays, but it is hard to set up a distinct line or to set this particular man apart.

Senator TAFT. Supposing you reduce the limit to about 6 months, that would practically cut out the fellow who was speculating?

Mr. SCHRAM. Yes; I think that would. Six months, of course, has been accepted by the Congress, I think, as a dividing line in that section in the S. E. C. Act relating to trading by officers and principal stockholders. That is, they are liable in suits by stockholders for any profits that may have been made on their trading up to 6 months. After 6 months, if there has been no suit, of course they are no longer liable. So I think the Congress has more or less set a precedent for a 6-month holding period. That would be very helpful, of course. Still I do not think you would get as much revenue as you would if you eliminated it completely.

Senator TAFT. Did not your testimony also tend to show if you went back from 25 percent to 15 percent on the long-term loans we would get more money rather than less?

Mr. SCHRAM. That is right.

Senator TAFT. You are opposed to the increase in this present bill from 15 to 25 percent?

Mr. SCHRAM. Yes. The 15-percent tax, in my opinion, would raise more revenue than the 25-percent rate. It must always be understood that this is a discretionary tax. It is not a tax that people have to pay. What we should do is to enable people to shift their securities or their capital assets and thereby pay the tax—encourage them to pay the tax.

Senator TAFT. As far as long-term gains are concerned, you see no disadvantage in separating them altogether from the normal income tax; do you?

Mr. SCHRAM. No; I think they should be separated.

Senator TAFT. Neither deduct gains nor losses on normal income tax?

Mr. SCHRAM. I agree with that. I think that is sound.

The CHAIRMAN. Are there any further questions?

If not, we thank you, Mr. Schram.

Mr. SCHRAM. Thank you very much.

The CHAIRMAN. Mr. Tripp.

STATEMENT OF L. E. TRIPP, LOS ANGELES, CALIF., REPRESENTING HULL HOTEL COMPANIES

The CHAIRMAN. Mr. Tripp, give your name, please, and your business.

Mr. TRIPP. My name is L. E. Tripp. I am a lawyer of Los Angeles, Calif. I am general counsel of the Hull Hotels, owning and operating six hotels in the State of California and one in the State of Nevada.

We are particularly concerned with the proposed income tax bill changing the method of taxing corporations that have a fiscal tax year different than a calendar year and making such legislation retroactive. We refer to section 108 entitled "Taxable period embracing years with different laws." We feel that in the case of many small corporations that the enactment of such legislation will put many of them out of business. We believe that such a change should not be retroactive principally for the following reasons:

1. In view of extremely high corporate taxes now existant many small corporations are finding it exceedingly difficult to pay off their existing obligations and to secure the necessary money with which to make the necessary repairs, rehabilitation and improvements upon their property which are necessary to be made if they are to remain in business. The only source most of them can get this money from is out of profits and profits are so curtailed at the present time, particularly for corporations not engaged in the war effort owing to the rising cost of commodities and labor that the profit bracket is becoming much lower year by year.

Many of these corporations, particularly the ones I have reference to, have set their fiscal policy for the ensuing year based upon what they firmly believe was to be their tax obligation. As a consequence thereof, these corporations have contracted large debts in order to enlarge their facilities, make the necessary repairs and improvements to their property in order to withstand competition.

These seven hotel companies have their fiscal years ending in the months from March 30 to June 30, which fiscal year coincides with the time these corporations actually commenced business. It was necessary for them to adopt the fiscal-year basis on these dates owing to their financial obligations. The fiscal years have now ended for all of these corporations; they have contracted large obligations, for enlargement, for the making of necessary repairs, and so forth, having first computed what they firmly believed was their Federal tax liability. If the present bill is made retroactive, existence of the corporation will be seriously jeopardized.

I might say in that connection, gentlemen, in the last 40 days we have had to negotiate new contracts with labor at a rise in cost of approximately 17 percent. In addition to that, we endeavored to pass some of that on to the public. Since that time, however, the Government has stepped in, and in Sacramento, has established a price ceiling on rentals, putting us back to March.

In addition to that, due to the rubber curtailment and lack of the traveling public, our revenue is very seriously curtailed.

In that connection, I would like to say that we are keenly aware of the momentous problem that is facing you gentlemen as to the astronomical figures that are required to be spent for the war effort in order to preserve our liberty and I am satisfied there is not one of us that would not make whatever sacrifices that are possible in order to preserve our liberty and win this war. On the other hand, taxes should not be increased to the point of diminishing returns. From an analysis of the present tax bill, I believe that a 45 percent normal income tax and surtax coupled with a 90-percent excess-profits tax would seriously jeopardize the existence of many small corporations. I am firmly convinced that the ceiling for both the normal and surtax rate on corporations should be 40 percent and the excess-profits tax rate should not exceed 80 percent. When the corporations are faced with any higher tax rates than the last-mentioned figures, the profit motive is disrupted if not almost practically destroyed, with a consequent rise in the cost of operation to the detriment of both the Treasury Department, the corporation, its employees, and stockholders.

There is another item I would like to touch on very briefly and that is a general sales tax. I fully appreciate that some other method of securing income must be devised in addition to our present source of obtaining revenue if the revenue requested by the administration is to be obtained. I believe that a general sales tax of not exceeding 5 percent would very materially aid and should be passed.

Senator TAFT. Would that cover hotel-room sales?

Mr. TRIPP. That would cover, I believe, every form of service; professional services, also.

In order to meet, however, the obligations of the wage earners and small-salaried classes, I would exempt from such tax necessary food commodities, clothing in the lower price brackets, and, of course, commodities or supplies used in the war effort. Such a tax thus framed would be practically painless as it is pay as you go and also such a tax would not meet the resistance from the people in the lower earning brackets. On the other hand, the person with larger income that has more expensive tastes would be taxed in direct proportion to his or her spending. California has had such a sales tax amounting to 3 percent in force for the last past several years. As a result of such a tax, the State's financial condition has been changed from the huge deficit to a surplus even though during such periods of time the amount spent on relief per capita was one of the largest in the United States.

I thank you very much for the privilege of appearing before you.

The CHAIRMAN. Thank you, sir, for your appearance.

Mr. Gadsby.

STATEMENT OF G. M. GADSBY, SALT LAKE CITY, UTAH, PRESIDENT AND GENERAL MANAGER, UTAH POWER & LIGHT CO.

The CHAIRMAN. Mr. Gadsby, upon what subject are you appearing?

Mr. GADSBY. I appear on behalf of the Utah Power & Light Co., presenting two phases of the effect of the proposed tax bill which are common to the industry at large, and probably to a good many other companies which, as is mine, are facing immediate refinancing.

The CHAIRMAN. I see.

Mr. GADSBY. The two features which I would have brought out, and would like to present to the committee, have to do with the effect of the excess-profits tax on an industry whose income is entirely regulated, with suggestions as to some modification of the effect of the tax on this type of company.

If I may, I will simply skip through the five-and-one-half-page statement which I have presented.

The company that I represent, as is noted in the statement, serves an area in Idaho, Utah, and Colorado, and the southwestern part of Wyoming. We are an electric utility, a holding company and a subsidiary of a holding company, all as defined by the Holding Company Act. And that is important because it makes us subject to the jurisdiction both of the Securities and Exchange Commission and the Federal Power Commission, we being also a licensee company.

The size of the company is indicated by the fact that during the last 12 months we have sold about a billion kilowatt-hours, about 700,000,000 of which have gone directly into war work

We have about $45,000,000 of bonds outstanding, in addition to the stock issues as noted. The securities of the company are held by about 25,000 separate owners, about 11,000 holders of the bonds and 14,000 holders of the stock.

We were able to maintain the dividend rate until the depression curtailed mining activities, which affected a large part of our industrial sales, and then we were not able to keep up our dividends. We entirely suspended them for a year and then picked them up at a later date.

We now have a large amount of accrued undeclared dividends.

All of our mortgage bonds expire in 1944, and we have to refinance about $45,000,000. The effect of the tax, of course, has a very serious effect on our ability to handle that refinancing. If we are able to follow the trend that has been established by recent refinancing operations we should be able to handle the new securities on a basis which would save us about $700,000. However, the proposed tax would take 72 percent of that and leave us with an interest coverage quite low and quite unable to pay our preferred dividends.

Senator BROWN. I do not see how you get the 72 percent.

Mr. GADSBY. It appears a little later in the prepared statement, Senator Brown, on page 4.

Based upon present refinancing trends we hope to evolve and have approved a plan which will reduce interest charges and amortization of debt expense some $700,000 a year. On the basis of this refunding and then applying the 1942 revenue bill, the 1942 Federal tax re-

quirements would be $2,477,000, an increase of $513,000 over the proposed taxes based upon the present funded debt. That is 72 percent of the total saving.

In addition to the taxes, all other prices entering into our operations have increased, as is common, of course, to every other line of activity.

The calculation of the application of the tax is shown in detail in my statement, and I will not go into it, but I want you to note that based on 1942 operations it is $1,963,000. It would leave a deficiency for the payment of preferred stock dividends amounting to $481.000.

Then follows the discussion already covered on the subject of refinancing. It shows while we may refinance on a favorable basis we lose a large measure of the gain accomplished by reason of the fact that as we decrease bond interest, the savings drop down into an equity position which is 100 percent subject to the operation of the excess-profits tax. Although, as a regulated industry, we really have no profits, and under no circumstances excess profits, but the calculation determined by the empirical formula as provided in the law does put our earnings into that position.

We respectfully suggest, sir, these difficulties may be overcome in two or three ways:

First, that a deduction be permitted to regulated companies, companies subject to entire price control, such as the utilities are, by deduction from income subject to the excess-profits tax, of debt reduction during the taxable year.

Second, that the excess-profits tax be made payable after rather than before normal and surtax deductions. That has merit, so far as regulated utilities are concerned, because the courts have held that all taxes are a part of the deduction before the calculation of return on the fair value of the company. Therefore, the normal and surtaxes, if deducted, would go in as an allowable deduction, but any profits remaining after the deduction of those normal and surtax amounts would then become subject to the excess-profits tax.

The third point is that preferred-stock dividends, plus a reasonable rate of return on the common stock, if earned, be allowed as a deduction from income subject to the excess-profits tax. That again gives recognition to the fact that it is a regulated industry with a rate of return determined by the regulatory commissions and would permit us to follow. in our financing, the principles laid down by the Securities and Exchange Commission, which insists upon a decreasing ratio of mortgage debt and a corresponding increase in equity financing.

Then I show the calculation on 1942 operations if any of these allowances be made. The reduction as suggested will not result in an entire loss to the United States Treasury but, as noted, here again there would be a return flow to the Federal Treasury, because the dividends paid would, of course, increase the income of the payee, either individual or corporation.

Finally, kilowatt-hours are becoming more and more a vehicle for conveying funds from the pocket of the rate payer to the Federal Treasury. I submit if they are to be used as such a vehicle,

all kilowatt-hours entering into commercial transactions should carry the same load, as far as expenditures and taxes levied for war expenditures are concerned. By that I mean there should be provision made whereby kilowatt-hours for war purposes should carry the same burden, whether flowing from publicly owned sources or privately owned sources. After all, as I say, they are simply a vehicle, simply a means of taking from the rate payer and conveying to the Treasury certain funds. In this respect I should like to submit that this burden be distributed evenly, regardless of the source of the generation.

That, with the statement before, completes what I have to say. Again I want to say, as my predecessors, that I appreciate the opportunity of coming before you.

The CHAIRMAN. Any questions?

Thank you very much for your appearance.

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

BRIEF ON BEHALF OF THE UTAH POWER & LIGHT CO., SUBMITTED BY G. M. GADSBY, PRESIDENT AND GENERAL MANAGER, SALT LAKE CITY, UTAH

Utah Power & Light Co. is an electric service utility company supplying an extensive area in eastern Idaho, northern Utah, and southwestern Wyoming. It owns all of the securities of the Western Colorado Power Co., and all the stock of Utah Light & Traction Co. excepting directors' qualifying shares. Utah Light & Traction Co. supplies transportation service in Salt Lake City, and The Western Colorado Power Co. supplies electric service in southwestern Colorado.

Utah Power & Light Co. is an operating electric utility, a holding company, and a subsidiary of a holding company, all as defined in the Holding Company Act of 1935. It is subject to the jurisdiction of the Federal Power Commission and the Securities and Exchange Commission. Its rates are regulated by State and Federal regulatory commissions.

For 12 months ended June 30 electric energy sales to approximately 124,000 customers amounted to 1,049,000,000 kilowatt-hours, of which almost 70 percent were used directly in war production work, and in copper and other critical metal mines, smelters, and industrial enterprises contributing directly to war production.

On June 30, 1942, there were outstanding 4½- and 5-percent bonds of Utah Power & Light Co. and Utah Light & Traction Co. amounting to $45,277,000; Power Co. 6-percent debentures—$5,000,000; Power Co. $7 preferred stock—207,605 shares, $6 preferred stock—41,921 shares; and Power Co. common stock—3,000,000 shares (all owned by Electric Power & Light Corporation).

The publicly held securities are widely distributed. The bonds are owned by some 11,000 holders; the preferred stocks by approximately 14,000 stockholders—averaging 18 shares each.

After 20 years of unbroken record in payment of preferred dividends the severe effect of the depression on mining activities made it necessary to suspend payments during 1933, and thereafter to pay partial rates until October 1, 1940, since when the full rate again has been paid. No payments have been made on the large amount of undeclared accumulated dividends.

All of the mortgage bonds of the combined companies in the hands of the public mature in 1944, necessitating refinancing approximately $45,000,000.

The impact of the Revenue Act of 1942, as it has passed the House of Representatives, will have a serious effect upon the company's ability to meet its financial obligations to the public represented by the holders of its bonds and preferred stocks, also its ability to refinance its maturing debt. The company has no excess profits. In fact, it has no true profits of any kind, nor has it had for over 10 years as is evidenced by the fact that it has been unable, after paying its interest, to pay in full its preferred dividends. Because of tax increases the amount left for the company after paying operating costs and fixed charges is declining month by month. This is true despite increasing operating revenues.

In 1941 the combined companies' Federal income taxes were $811,000, an increase over 1940 of $380,000. Applying the 1942 revenue bill to 1941 operations would produce Federal income and excess-profits taxes of $1,421,000; an increase of $610,000 or over 75 percent. This would have left 1941 net income available for preferred stock dividends $350,000 less than the dividend requirement.

In addition to taxes, all costs of operation and maintenance are increasing; for instance, Utah Power & Light Co. use of coal in 1942 at September 1 prices will cost approximately $860,000 f. o. b. cars at generating plants. This same coal at prices as of September 1 of each year would have cost: 1938, $785,000; 1935, $734,000. Coal prices have thus increased 17 percent in 7 years. The June 1942 monthly operating pay roll for the company was $245,000. The corresponding monthly pay roll for the same employees during the same work would have been $222,000 in 1938 and $190,000 in 1935, an increase in 7 years of 29 percent. Poles, cross arms, hardware, and other items have substantially increased in price.

A contrawise trend is found in prices received for electric service, the average price per kilowatt-hour sold by the company for 12 months ended June 1942 being 1⅓ cents, a decrease of 30 percent since 1935. The average residential rate is now 3¼ cents, again 30 percent under the 1935 price.

The following is a calculation of Utah Power & Light Co. and subsidiaries estimated 1942 consolidated normal and surtax and excess-profits tax based on the revenue bill of 1942 (6 months actual operations and 6 months estimated):

Estimated net taxable income, year 1942			$3,198,872
Plus 50 percent of interest on borrowed capital			1,271,250
Excess-profits net income, invested-capital basis			4,470,122
Invested-capital credit:			
8 percent on first $5,000,000	$400,000		
7 percent on next $5,000,000	350,000		
6 percent on balance ($43,990,533)	2,639,432		
		$3,389,432	
Specific exemption		10,000	
Total credit			3,399,432
Adjusted excess profits, net income			1,070,690
Excess profits tax on above at 90 percent			963,576
Normal and surtax:			
Net income per above		$3,198,872	
Amount subject to excess-profits tax per above		1,070,690	
Amount subject to normal and surtax		2,128,182	
Normal and surtax on above at 47 percent (consolidated)			1,000,269
Total tax			1,963,845

These taxes deducted from 1942 income available for dividends leave $1,223,000 to meet preferred-stock dividend requirements of $1,704,000, an indicated deficiency of $481,000.

Plans are being made for refinancing the $45,000,000 of bonded debt maturing in 1944, and in due course declaration will be filed with the Securities and Exchange Commission. Based upon present refinancing trends, we hope to evolve and have approved a plan which will reduce interest charges and amortization of debt expense some $700,000 a year. On the basis of this refunding, and then applying the 1942 revenue bill, the 1942 Federal tax requirement would be $2,477,000, an increase of $513,000 over the proposed taxes based upon present funded debt. Over 72 percent of the saving resulting from refinancing is lost in additional taxes. Interest after payment of all taxes and provision for depreciation and retirements on the new issues would be earned 1.74 times, and annual preferred dividend requirement would be short $290 000. Under these conditions it is extremely doubtful if a market can be found for such bonds. The cost of refinancing and debt servicing will be grievously increased and the future of the company be placed in jeopardy.

As alternative measures, the following are respectfully suggested:

1. That a deduction be allowed from income subject to excess-profits tax, of debt reduction during the taxable year, thereby following the suggestion made by your honorable chairman, as reported in the newspapers of July 30.

2. That the excess-profits tax be made payable after, rather than before, normal and surtax deductions, thus recognizing that regulated utilities should pay excess-profits taxes only if their earnings after normal and surtaxes exceed the excess-profits tax credit allowed nonregulated business.

3. That preferred-stock dividends, plus a moderate rate of return on common stock (if such be earned) be deducted from income subject to excess-profits tax. This again gives recognition to the fact that utilities must earn a reasonable return on all invested capital regardless of the method of its financing.

Such return does not imply a profit as ordinarily conceived. Failing to earn such a return, it becomes impossible to attract capital for refinancing on a basis compatible with prevailing interest rates or to attract additional funds as required. This procedure would have the further benefit of permitting future financing on the basis advocated by the Securities and Exchange Commission, which insists upon a decreasing ratio of mortgage debt and corresponding increase in equity financing.

The dollar effect on Federal tax payments and balance available for preferred dividends applying any of the above suggestions, based on our 1942 revenues, would be as follows:

Federal income taxes	$1,503,470
Reduction from 1942 revenue bill	460,375
Balance after annual preferred dividend requirement (deficit)	*21,702*

Based on 1941 operations, the electric utilities are paying Federal taxes amounting to $294,000,000, an increase of $104,000,000 over 1940. It is estimated that Federal taxes for 1942 to be paid by electric utilities under the 1942 revenue bill will be further increased $225,000,000, of which $150,000,000 will be in the excess-profits bracket as compared with $45,000,000 excess-profits tax in 1941. All utility taxes in 1942 will then take about 25 percent of gross receipts.

Reducing the excess-profits tax provision will not mean a corresponding loss to the Federal Treasury, because, as we of the West say of irrigation water, "there is always a return flow to the stream." There will be a return flow of taxes to the Federal Treasury if the electric utilities are permitted to continue payment of dividends, both preferred and common, since such dividend payments represent individual and corporate income to the payee and become subject to taxes at the applicable rates in his normal and surtax brackets.

One final point, if kilowatt-hours are to be used to an increasing degree as the vehicle for conveying dollars from the rate-payer's pocket to the Federal Treasury, then in all fairness this same duty should be imposed upon all kilowatt-hours. Each kilowatt-hour sold by the private companies in 1942 would carry a load of over 3½ mills to the Federal Treasury in present taxes and the increases proposed in the proposed revenue bill. In the long run the consumers pay the bill, and the present exemption of kilowatt-hours generated by publicly owned projects constitutes a discrimination, not so much between public and private ownership as between the 28,000,000 consumers taking from the private utilities and the 4,000,000 consumers supplied from publicly owned systems. Since so large a part of the Federal taxes are now used for war purposes, certainly for the duration, all kilowatt-hours, regardless of ownership of their source, should share equally in supporting the war for the preservation of liberty.

The CHAIRMAN. Mr. Banser.

STATEMENT OF JOHN C. BANSER, NEW YORK, N. Y., REPRESENTING THE NETHERLANDS CHAMBER OF COMMERCE IN NEW YORK, INC.

Mr. BANSER. Mr. Chairman and members of the committee, my name is John C. Banser. It is erroneously stated on the calendar that I am appearing for my firm. I am appearing for the Netherlands Chamber of Commerce. To be sure, I am of the firm of Willkie, Owen, Otis, Farr & Gallagher.

I am appearing here solely to speak about section 106 of the present House bill, which amends section 211, raising the rate on nonresident aliens from 27½ percent to 37 percent. Unfortunately, nonresidents are in no position, even in peacetime, to appear here, and in these days are absolutely cut off from appearing here to speak for their interests. So the Netherlands Chamber of Commerce in New York City asked me to come down and speak to you.

I appeared before this committee in 1936 when, for the first time, what I may call a discriminatory rate of tax was placed on nonresidents, discriminatory as between nonresident aliens on one side and resident aliens and United States citizens here, and they are discriminatory, because under that act a man with $1,000 income paid no tax if he was a resident alien or a citizen, whereas a nonresident had to pay a $100 tax. There was no exemption whatever. That rate has gone up from 10 to 16½, to 27½, and now proposes to go up to 37.

I do not object, neither do the people whom I speak for, to the 37 rate as a rate, but the objection is that whereas a man with a $500 income under the new act will pay no tax if he happens to be a resident alien—and there are some here—whereas the nonresident will pay $185 on the same income. Now, that is a great discrimination, and that is not in keeping with the policy of this Government as expressed by Secretary Morgenthau before the House Ways and Means Committee, and I would like to quote a brief statement. He says:

> I come now to a third and most insistent need that should govern our wartime fiscal program. That is, the need of holding fast to the basic principle of our tax system; namely, that taxes should be fair and nondiscriminatory and imposed in accordance with ability to pay.

Now I submit to your committee, that the discrimination, while great already when it was 10 percent, is almost unbearable at 37. Now, to show how inequitable that discrimination is, when we come to a $22,900 received by a nonresident alien, we do not discriminate, we give him the same rate as we give ourselves. The statistics which I produce here in the brief from the Dtuch Government will show that 99 percent of the total income recipients—and I can only speak for them—fall far below the $22,900 income. Ninety-nine percent will fall below that figure, and a vast majority will fall into the $1,000 class and below, deriving income from this country. What do we do with those little fellows; the 99 percent? We say: "You are going to pay more than a compatriot of yours who happens to be here." But the big fellows, a handful of them, as I show by the percentage there, we say to them: "Now, you are on the same basis as the American citizen." That is contrary to the policies expressed by Mr. Morgenthau that I just quoted. The discrimination is extreme.

Now, you may say: "This is all criticism; what do you suggest?" Up to 1936, there was no discrimination, the only thing was that they were not allowed to deduct anything for dependents. That was a negligible discrimination. In other words they were allowed only to deduct $1.000, like a single individual. In 1936 they were not allowed to deduct anything, they had to pay a flat rate of 10 percent on gross income.

As I point out here, your nonresident aliens, as far as I can speak for them, like the flat rate. They like it better than the old system

of having to make a return and squabble over a $5 or $10 tax, and they could not afford to hire a lawyer to straighten them out. From the beginning they said: "Fine; a 10-percent tax." Now, it has gone up to a point where it becomes practically unbearable.

There are a lot of Dutch investors who realize a very small income from this country, and their whole income, as shown by the records, is very small; $37 on even a $100 income is going to be a great burden to them.

You are doubtless aware of the fact that the Dutch investors built, to a large extent, our transcontinental railroads. I pointed it out in my brief the last time I was before the committee. Those securities are still held by small investors, distributed by the institution in Holland and other places. They helped to build our basic industry.

What happened in England when the tax rate went up to 20 percent on nonresidents? The Dutch investors in England withdrew their securities. Now, it is going up higher, so there are no Dutch investors in England.

The Dutch investors cannot, under existing circumstances, withdraw their cash from here. Some will say, "Let them withdraw it." I do not think that is the policy of the Government. It has never been. We have been trying to attract foreign capital in helping us to build up the country. I am sure, after the war stops, if the 37-percent rate remains, they are going to withdraw their capital from the country and seek investments elsewhere.

Now, you say what do I propose. Some discrimination must exist. The Treasury Department finds it easy to collect the tax by withholding, and the foreigners like it. So I suggest that the line of demarcation should not be drawn at $22,900, but should be drawn at, say, $3,000, on which we should pay approximately 15 percent on a single individual, with nothing but the $500 exemption and his earned income credit, putting the foreigner and the citizen in the same class. If somebody had a higher income than that, then they would pay a higher rate. Even when we make them pay 15 percent on less than a $2.000 income he would pay more than we do here. Somewhere a line should be drawn. So I suggest the section should be amended not to increase from 27½ to 37 percent but to cut it down to 15 percent, on the basis of my argument presented here.

The CHAIRMAN. Are there any questions from Mr. Banser?

(No response.)

The CHAIRMAN. Thank you very much, Mr. Banser.

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

BRIEF BY JOHN C. BANSER, NEW YORK, N. Y., ON THE PENDING 1942 REVENUE BILL AS IT WILL AFFECT NONRESIDENT ALIEN INDIVIDUALS

This statement is presented to your committee at the request of the Netherlands Chamber of Commerce in New York, Inc. Because Dutch recipients of income from sources in the United States are at present cut off from direct appeal to this committee, the aforesaid chamber of commerce feels that it is under obligation to present their claim for your consideration. Although this statement is made directly on behalf of the aforesaid Dutch recipients of income from sources in the United States, it is reasonable to assume that the facts herein set forth and the conclusions reached are applicable to all nonresident aliens deriving income from sources in the United States which is subject to the tax.

A BRIEF HISTORY OF THE UNITED STATES INCOME TAX LAW AS APPLICABLE TO NONRESIDENT ALIENS

Prior to the 1936 Revenue Act, nonresident aliens paid substantially the same tax as did United States citizens and resident aliens on a corresponding amount of income, the only difference being that nonresident aliens were not allowed deductions for dependents. Thus, for 23 years (1913–36) the taxing policy of the United States was to assess the same tax on the same income, whether received by a citizen or a nonresident alien. This was equitable to all taxpayers.

The 1936 Revenue Act changed all this, because then for the first time in almost a quarter of a century of tax legislation the United States imposed a tax upon nonresident aliens different from and greater than that imposed upon citizens and resident aliens. Under that act even a single individual citizen or resident alien, with no dependents, having a net income of $1,000 paid no tax whatever, while a nonresident alien, whether single or married, paid $100 tax on the same amount of gross income, the rate being 10 percent with no exemption or deduction allowed. This was not equitable to nonresident aliens as it discriminated greatly against them.

When your committee was holding public hearings on the said 1936 Revenue Act, I presented a statement to your committee on this subject matter, from which I beg to quote, as follows:

"I believe that I am correct in stating that the proposed revenue bill, if enacted into law, will be the first Federal income-tax law to impose upon nonresident alien individuals a rate of tax different from the rate applicable to citizens of the United States on identical amounts and character of income. In the previous and the existing tax laws, the only discrimination against foreigners was that they could not take deductions for dependents."

The 1940 Revenue Act increased the rate to 16½ percent, and the 1941 act to 27½ percent, and the pending bill (H. R. 7378) now proposes to raise the rate to 37 percent. Thus, each act has broadened the inequality set up by the 1936 Revenue Act and increased the discrimination as between taxes paid by citizens and resident aliens on the one hand and nonresident aliens on the other hand.

COMPARISON OF TAX TO BE PAID BY A UNITED STATES CITIZEN OR RESIDENT ALIEN, SINGLE INDIVIDUAL, ON ONE HAND, AND A NONRESIDENT ALIEN, WHETHER SINGLE OR MARRIED, ON THE OTHER HAND

In order that this committee may readily visualize the great inequality between a citizen and a resident alien on one hand and a nonresident alien on the other, if the proposed rate of 37 percent is enacted, I submit below a comparative table showing the tax a nonresident alien will pay on the basis of 37 percent and the tax a citizen and a resident alien will pay under the new act on the same income. In order to make this comparison as nearly actual as possible, the tax on a citizen and resident alien is computed for a single individual with no deductions from his gross income other than the $500 personal exemption and the earned income credit. In other words, the tax listed below is the maximum tax that will be paid by a United States citizen or resident alien.

Gross income of United States citizen, resident alien or nonresident alien individual	Tax paid by United States citizen or resident alien	Percent of gross income, normal and surtax	Nonresident alien individual will pay 37 percent on gross income	Gross income of United States citizen, resident alien or nonresident alien individual	Tax paid by United States citizen or resident alien	Percent of gross income, normal and surtax	Nonresident alien individual will pay 37 percent on gross income
		Percent				*Percent*	
$500			$185	$12,000	$3,118	25.98	$4,440
$1,000	$89	8.90	370	$13,000	3,512	27.01	4,810
$2,000	273	13.65	740	$14,000	3,926	28.04	5,180
$3,000	472	15.73	1,110	$15,000	4,366	29.10	5,550
$4,000	686	17.15	1,480	$16,000	4,826	30.16	5,920
$5,000	920	18.40	1,850	$17,000	5,301	31.18	6,290
$6,000	1,174	19.56	2,220	$18,000	5,791	32.17	6,660
$7,000	1,448	20.68	2,590	$19,000	6,296	33.13	7,030
$8,000	1,742	21.77	2,960	$20,000	6,816	34.08	7,400
$9,000	2,056	22.84	3,330	$21,000	7,351	35.00	7,770
$10,000	2,390	23.90	3,700	$22,000	7,901	35.91	8,140
$11,000	2,744	24.94	4,070	$22,900	8,408	36.71	8,473

It will be noted that the taxes paid by a single individual, United States citizen or resident alien, and that paid by a nonresident alien individual on a $22,900 income, are approximately equal, but when the income exceeds that figure, the tax paid by a United States citizen or resident alien is likely to exceed the tax that would be paid by a nonresident alien on the same income. Hence, in order that such nonresident alien may not pay less tax than does a United States citizen, or a resident alien, it is provided in the proposed revenue act that a nonresident alien individual, with an income in excess of $22,900, shall file a return and pay either the same normal and graduated surtax as does a United States citizen or 37 percent of his gross income, whichever is greater.

The foregoing schedule clearly demonstrates that the proposed rate of 37 percent will act equitably only in respect of those comparatively few nonresident aliens whose taxable gross income, from sources in the United States, exceeds $22,900 per annum; whereas it will act most inequitably against those with an income below that figure. As will be shown hereafter, insofar as residents of Holland are concerned, the vast majority of nonresident aliens derive income from sources in the United States far below the figure of $22,900. This great discrimination against nonresident aliens is contrary to the tax policy of the United States as applied to its own citizens and to resident aliens whose income falls in the lower brackets. The Secretary of the Treasury, in a statement before the House Ways and Means Committee on March 3, 1942, is reported to have stated that:

"I come now to a third and most insistent need that should govern our wartime fiscal program. That is the need of holding fast to the basic principle of our tax system; namely, that taxes should *be fair and nondiscriminatory* and imposed in accordance with ability to pay." [Italics mine.]

The Honorable Secretary of the Treasury correctly enunciated the tax policy of the United States that it should be "fair and nondiscriminatory." It cannot be assumed that the Secretary of the Treasury had in mind only citizens and resident aliens as falling within the policy mentioned; rather is it reasonable to assume that the "fair and nondiscriminatory" policy of our Government is intended to apply to nonresident alien taxpayers as well. It is neither fair nor equitable to tax a nonresident alien $185 on a $500 income from sources in the United States when no tax whatever is imposed on a citizen or resident alien with the same income. Especially is this inequitable when we consider that the nonresident alien will have to pay an additional tax to his own government on this same income.

The next logical inquiry is: What proportion of nonresident aliens, receiving income from sources in the United States, are likely to be thus discriminated against?

While we have no exact available data which would furnish the answer to this question, we do have available some reliable information in respect of the number of Dutch people whose taxable income can be placed in the categories listed above.

The following data is taken from the 1940 publication of the Netherlands Government Central Bureau for Statistics, showing in detail the taxable income, from all sources, of Dutch taxpayers, reduced into dollars at the rate of 55 cents to a guilder. This compilation is for the fiscal year 1938–39, being the latest available.

Income group	Number of taxpayers	Income before exemption for children	Income group	Number of taxpayers	Income before exemption for children
$440 to $770	648,649	$384,450,000	$11,000 to $16,500	3,319	$44,000,000
$770 to $1,100	369,295	331,550,000	$16,500 to $55,000	2,921	75,900,000
$1,100 to $1,650	183,599	240,350,000	$55,000 and upward	341	51,700,000
$1,650 to $2,750	100,474	206,800,000			
$2,750 to $5,500	46,169	169,950,000	Total	1,364,408	1,613,700,000
$5,500 to $11,000	14,641	108,900,000			

As appears from the first three lines of the foregoing data, 1,196,543 out of 1,364,408 taxpayers in Holland, or approximately 88 percent, received income from all sources, of not more than $1,650 in the fiscal year 1938-39. No doubt, there is some income from sources in the United States comprised in a great many of those comparatively small incomes, as American securities are widely distributed in the Netherlands among the small investors. But, obviously, such incomes from American sources, if received by citizens of the United States or resident aliens would either pay no tax at all or fall within the lowest brackets, depending upon allowable exemptions and deductions, if any, yet, nonresident aliens will be required, under the proposed revenue act, to pay 37 percent on even the lowest amount of income, in addition to the taxes they are required to pay in Holland.

An additional 100,474 taxpayers, or 7.36 percent of the total taxpayers appearing in the fourth line of the above schedule, have a total income between $1,650 and $2,750. Again, on the part of that income, which he derives from his American securities, the Netherlands recipient of such income will be required to pay 37 percent on the full amount of his income as against approximately 15 percent that will be paid by a United States single individual, or a resident alien. And the act provides no remedy for those cases—which are the rule, not the exception—where nonresident aliens pay much more than citizens or resident aliens, although the few nonresident aliens with larger incomes ($22,900 and upward from sources in the United States) are placed approximately on the same basis as citizens with corresponding taxable net incomes.

It is evident from the foregoing schedule that the more substantial amounts of American securities are held by the greater capitalists in Holland. It would be highly interesting if we could establish an approximate average of individual holdings of United States securities in Holland. The publication of the United States Department of Commerce, entitled "Foreign Long Term Investments in the United States, 1937-39" gives us some valuable information. As of the middle of 1937, we find:

"Dutch holdings of United States common and preferred stocks—$564,000,000, with an income of $21,528,000.

"Dutch holdings of United States corporate bonds—$215,000,000 with an income of $8,550,000."

The above listed total income of $30,078,000 was received by individuals, partnerships, and corporations in Holland. The table listed above, showing the various income groups in Holland, gives only the incomes of individuals. Yet, assuming that the above-mentioned $30,078,000 were all received by the 67,891 individual taxpayers listed below the fourth line in the aforesaid schedule, we find an average of less than $450 from United States sources. If we apportioned them exclusively to the income group above $11,000, we would have only 6,581 taxpayers and an average income of about $4,570 from United States sources, on which a single United States citizen or resident alien would pay approximately 18 percent as against the 37 percent proposed on nonresident aliens.

In 1938, the Amsterdam Stock Exchange requested all organized bankers and brokers, approximately 1,800, in the Netherlands to list the number of individual clients in each graduated group of income from American sources. Answers were received from 674 bankers and brokers which disclosed the following interesting, even if incomplete, picture:

Income in 1937 out of dividends of American shares and from interest of American bonds:

	Number of clients residents of the Netherlands who enjoyed income out of American securities in 1937
Income group up to $1,000	59,143
Income group over $1,000 up to $1,500	783
Income group over $1,500 up to $2,500	481
Income group over $2,500 up to $3,500	175
Income group over $3,500 up to $5,000	94
Income group over $5,000 up to $6,500	37
Income group over $6,500 up to $8,000	31
Income group over $8,000 up to $10,000	21
Income group over $10,000 up to $12,500	13
Income group over $12,500 up to $15,000	8

	Number of clients residents of the Netherlands who enjoyed income out of American securities in 1937
Income group over $15,000 up to $17,500	10
Income group over $17,500 up to $20,000	7
Income group over $20,000 up to $25,000	4
Income group over $25,000 up to $30,000	3
Income group over $30,000 up to $35,000	
Income group over $35,000 up to $40,000	
Income group over $40,000 up to $50,000	3

The foregoing figures compare well with the figures listed from the Netherlands official sources previously mentioned. It is evident from this and the previous schedule that there are only a comparatively few persons in Holland whose income from American sources brings them into the category who will be required to file returns under the new act because they receive more than $22,900. Such persons can only be found among the 3,262 taxpayers with income, from all sources, exceeding $16,500, shown on the previously mentioned schedule. So that the 1,361,146 Dutch taxpayers shown on the said schedule are penalized and discriminated against by requiring them to pay a much greater tax than citizens and resident aliens are required to pay on the corresponding income; whereas the few with larger incomes, only 11 on the immediately preceding schedule, and therefore more able to pay, are not discriminated against because they are required, if their income should exceed $22,900, to pay the same rate as do United States citizens and resident aliens, with only the limitation that they shall not pay less than 37 percent.

At the time that the 1941 revenue tax bill was in the process of enactment, a statement was made to the effect that the proposed increase in the tax to be paid by nonresident aliens was in the same proportion as the increase to be paid by citizens in this country. This statement was correct only to the limited extent of the number of nonresident aliens whose income exceeded $23,000. But as to more than 99 percent of the Dutch taxpayers, whose income from all sources do not exceed $16,500, that statement was incorrect. The increase from 10 to 16½ percent and again to 27½ percent and now to 37 percent simply magnified the great inequality that was initiated in the 1936 revenue act.

It may possibly be urged that the existing rate of 27½ percent on nonresident aliens and the proposed 37 percent is still less than is paid on dividends and interest in England where the rate is 50 percent on nonresident aliens. There is, however, a great difference in the principle which makes the British rate of 50 percent less objectionable than even the existing 27½ percent rate in this country. Although in England, as in the United States, there is some discrimination between residents and nonresidents owing to lack of the right to certain exemptions and credits, there is no discrimination as to the basic rates. An English single individual, with an income of £2,500 or $10,000 from all investments pays 49.18 percent, a married couple with children pays 48⅛ percent, and a nonresident alien pays 50 percent. This shows but a negligible discrimination, whereas on a corresponding income here a United States single individual or resident alien, as shown by the previous schedule herein, will pay approximately 24 percent under the new tax law; while a married couple with two dependents will pay approximately 19.4 percent, as against 37 percent that will be required to be paid by a nonresident alien—a difference of approximately 50 and 90 percent, respectively. This is the percentage of discrimination on incomes of $10,000, but for the vast majority of smaller incomes, in which class the Dutch investors fall as shown by the foregoing schedule, the discrimination is much greater.

THE INEVITABLE EFFECT OF THIS GREAT DISCRIMINATION ON FOREIGN CAPITAL IN THE UNITED STATES

The 50-percent British rate, and even the lower rates previously levied have been prohibitive for foreign investors in Great Britain. In the Netherlands, holdings of British securities, except of tax free Government loans, have disappeared ever since the rate rose to 20 percent.

When we regard the matter from this angle, the question of excessive, discriminatory taxation of the foreign investor assumes an aspect of much more general importance than the fate of the Dutch taxpayer. The question arises whether it is indeed a good policy to drive out the foreign investor and to close the United States to foreign capital, thus changing a policy that had its inception at the close of the Civil War.

The participation of foreign capital in American enterprises has been traditional in the economic history of the United States. The era of railroad construction, following the Civil War, and the subsequent industrial development attracted a steadily increasing number of European investors. Although the relative importance of capital involved has receded in proportion to the increase of this Nation's wealth, it can be said that this foreign capital and the international contacts which it brought as a corollary have been appreciated and deemed of mutual benefit. Up to the present time, American business has attached value to foreign participation in their issues of new securities, knowing that the European investor is conservative and, as a rule, buys for permanent investment.

For a better understanding, it is useful to give some data from the publication of the United States Department of Commerce, "Foreign Long-Term Investments in the United States 1937-39".

In the middle of 1937, the total of foreign long-term investments in the United States was calculated at $6,907,000,000; that amount was divided as follows:

Direct investments	$1, 883, 000, 000
Common and preferred shares	3, 808, 000, 000
Corporate bonds	565, 000, 000
Miscellaneous	651, 000, 000
Total	6, 907, 000, 000

The principal participants in that total were:

	Investment	Income received in 1937		Investment	Income received in 1937
United Kingdom	$2, 743, 000, 000	$120, 782, 000	Belgium	$142, 000, 000	$6, 260, 000
The Netherlands	970, 000, 000	42, 893, 000	Sweden	51, 000, 000	5, 019, 000
Switzerland	763, 000, 000	36, 226, 000	Denmark	17, 000, 000	548, 000
France	408, 000, 000	16, 429, 000	Norway	10, 000, 000	339, 000
Germany	124, 000, 000	4, 547, 000			

The investments in this country by citizens of the United Kingdom to the extent of $2,743,000,000 (to which have to be added very substantial dollar balances) have served in a manner that gives a striking example of the fact that such foreign investments can be of very great mutual benefit, especially in time of war. The proceeds of the gradual liquidation of those interests, since the commencement of the present war, have been applied to the payment of British purchases in this country. If it had not been for these holdings, lease-lend assistance necessarily would have been correspondingly higher, as out of them Great Britain was enabled to finance its first purchases, after the outbreak of the war, at a time when lease-lend had not been authorized.

A glance at the list shows that the rest of the foreign investments are chiefly owned by countries which, being occupied by the enemy, are solidly blocked. It is and has been impossible for the owners of those securities to take action with regard to tax measures imposed upon them since the outbreak of the war.

It is likely that after the war, if no remedy from the excessive taxation is provided, the foreign holders, if unblocked, will sell out, or, if their governments need foreign exchange, the securities will be sold by those governments. So the advantage to be reaped by the discriminatory taxes by the Government of the United States is bound to be of a very short duration, but the fact will remain, that, in time of war, those foreign investors have not received equitable treatment under conditions already so trying for them.

In this connection allow me to mention that Holland, itself a creditor nation for centuries, has nevertheless always welcomed foreign capital and treated foreign investors most liberally. Up to the time of the invasion (May 1940) only 2

percent tax was charged to foreign owners on incomes from coupons and dividends of Netherland securities; while for the Netherlander the same revenue forms part of his heavily taxed income.

To a large extent, the compiled data and other factual information herein contained were furnished by Mr. Albert Andriesse, a citizen of the Netherlands but presently residing in New York City, having arrived in the United States in June 1941. Mr. Andriesse was formerly a partner in the banking house of Pierson & Co., in Amsterdam, Holland, and is now associated, in an advisory capacity, with the investment banking firm of Hallgarten & Co. in New York City. Because of his long experience and wide knowledge of international investments and other financial transactions, and because of his particular knowledge of international taxation, Mr. Andriesse was of great help in the preparation of this statement. Acknowledgment is also made to Mr. Adolphe Boissevain, formerly a citizen of the Netherlands but now a citizen of the United States, for his helpful suggestions in the preparation of this statement.

CONCLUSION

(1) Both from the point of view of the United States Government and the nonresident alien, a flat rate of tax to be withheld at the source is preferable to a normal tax and graduated rate of surtax.

(2) It is not possible to administer such a flat rate of tax with complete equality of taxes as between United States citizens and nonresident aliens; hence, an arbitrary line must be drawn at some amount of income and some rate of tax.

(3) The proposed line of demarcation at $22,900, and the corresponding demarcation in the previous acts, operates with great inequality to the vast majority of nonresident aliens because they pay a much higher tax on a corresponding income than do United States citizens and resident aliens. The few nonresident aliens with income above $22,900, are not discriminated against although they could, no doubt, bear the payment of discriminatory taxes better than those in the lower income group.

(4) In view of the fact that an arbitrary line must be drawn, it is suggested that a flat rate of 15 percent be fixed and withheld from all income of nonresident aliens, and the demarcation be drawn at say, just below $3,000, on which a citizen, single individual, pays approximately 15-percent tax. While this would still be discriminatory against the vast majority of nonresident aliens, having income less than $3,000 from the United States, the discrimination would not be so great as to constitute an unbearable burden upon the nonresident alien.

(5) An alternative proposal is submitted to your committee, which is to the effect that if the proposed rate of 37 percent is to be enacted, a provision should be inserted in the income tax act which would make possible a refund to those nonresident aliens who could prove to the satisfaction of the Treasury Department that too much tax had been withheld, taking the same rates of taxation as those applicable to taxpayers in the United States, but, as at present, without allowing the nonresident any exemption or deduction. This system would require much clerical work for the Treasury Department, and this fact would offer a legitimate basis for fixing a minimum rate of say 10 percent, below which no refund would be granted. By this method our Government would still receive tax from nonresident aliens in a much larger proportion than is received from citizens on a corresponding income

JOHN C. BANSER.

The CHAIRMAN. Mr. Royce.

STATEMENT OF ALEXANDER BURGESS ROYCE, NEW YORK, N. Y., REPRESENTING PATINO MINES & ENTERPRISES

Mr. ROYCE. Mr. Chairman, my name is Alexander B. Royce. I am an attorney, practicing in New York City. I am appearing on behalf of the Patino Mines & Enterprises Consolidated, of which I am the general counsel and vice president.

I ask leave to submit for the record a memorandum relating to section 131 of the Internal Revenue Code, and my brief remarks will be supplemental only to that memorandum.

Last week Mr. Mitchell B. Carroll appeared before the committee to suggest a broadening of the credit section 131 so as to permit a credit against the United States taxes of those taxes paid in foreign countries which perhaps were not exactly within our definition and conception of income tax. He pointed out, for example, that other countries, such as Guatemala and Cuba, have adopted an empirical method of tax having somewhat the same result as income tax, but up to now they have not had a credit against their taxes here. He suggested the exact language for an amendment of section 131, which would permit the credit, where a foreign tax had been imposed in lieu of an income tax. He did not have before him the present situation in regard to Bolivia, and that is the purpose of my appearance here.

The principal outputs of Bolivia are today strategic metals, tin, tungsten, and antimony. The revenues of the Bolivian Treasury are mostly dependent upon the taxes that can be imposed upon these mining industries.

Most of the companies conducting mining operations in Bolivia are organized in countries other than the United States, particularly Chile, some are, I believe, English companies and, so far as I know, the company I represent is, by all odds, the most important United States company operating in Bolivia. We operate mines in Bolivia and do no other business. Our purchases, incidentally, of equipment here in the United States exceed $1,000,000 a year, but so far as conducting business is concerned, it is all conducted in Bolivia, where we operate the largest tin mine in operation today in the world. We produce one-third of the tin production of Bolivia. Our tin is shipped to England to be smelted there, and reaches the Allied war effort through England rather than through the United States. Many of the other companies producing tin have recently made arrangements with our Metals Reserve for the building of a smelter in Texas, to which their tin is shipped, smelted, and becomes part of the war effort through the United States.

Senator CLARK. It has heretofore practically all been shipped to England?

Mr. ROYCE. That is correct. But our tin is not now shipped to the United States because, as our Government knows and heartily subscribes to, we are under a long-term contract with the British Government to continue to ship there and smelt there, so long as war conditions do not hamper it. If ever they do hamper, then the provision is that this tin would immediately come to the United States, to be smelted here and come into the war effort through the United States, and we would be prepared to build a tin smelter, if the one in Texas is not sufficient for that purpose. But at the moment our tin is all shipped to England, and the shipment is paid for, of course, in pounds sterling.

Senator RADCLIFFE. Are you getting adequate transportation facilities?

Mr. ROYCE. I would like to knock on wood, but up to now we have not lost a ship. Under the urgency of the situation, with the hearty approval and request of our Government agencies, we are doing everything we can to increase our output.

Only yesterday I talked again with Mr. Henderson, the head of the Metals Division of our War Production Board, who is entirely

familiar with it, and he authorized me to say that while he did not venture to comment in any way upon the technical phase of tax matters, they were very sympathetic to anything that could be done to encourage us or other United States capital in Bolivia, to increase the tin output.

Now I come to the point that has hampered and handicapped the United States companies, and no other companies that are operating in Bolivia, which makes it necessary for me to ask a further change in section 131, the change which appears in my memorandum, in addition to that suggested by Mr. Carroll. Bolivia has had, for 20 years, an income-tax law, an income tax on mining profits, net mining profits, which has been recognized here as a credit. It was found in 1939 in Bolivia that they had not realized the full amount of revenue from that income tax, to which they were probably entitled, by reason of the inability to adequately administer the law, to determine the net incomes, and to collect the tax.

Also the condition of the Bolivian Treasury was and is such that they feel they must take their tax as the products are produced and revenue received by the mining company, instead of waiting until the end of the year and the filing of returns. So Bolivia passed a law or decree, which appears in my memorandum, in 1939, which added two taxes to that income tax. One was a tax on gross profits and the other was called an additional tax, as part of the same law.

The gross-profits tax is based on 30 percent of what the miner receives on the sale of his ores. That is rather the starting point for the tax. Somebody attempted, like Mr. Carroll referred to in the short-cut adopted by Cuba and other countries, to get at something that they could work from. They adopted a base of 30 percent of revenue. The scale of tax appears in my memorandum.

I may say as to that tax we now receive a credit in the United States from a very happy coincidence as appears in the memorandum. The Bolivian authorities being aware of the situation in respect to the few United States companies involved said that so long as the Treasury received just as much, any company subject to double taxation in other countries might pay under the old income-tax law instead of the gross profits-tax law. So that it works out as to that all right. But the additional tax appearing in the same decree is four times as great in our case as the tax for which we have a tax credit at present, and it is that portion of the 1939 tax which makes necessary either an expansion of section 131 as proposed, or some other change in our existing law.

I might say that this matter has been brought to the attention of the Treasury, which is giving it sympathetic consideration, but I felt I should appear now, in view of your consideration of the possible change in section 131 which would not meet our point if it says only that a tax in lieu of an income tax may be allowed as a credit.

Now, frankly, when you study this additional tax you see that it looks a good deal like a sales tax, and it is perhaps a somewhat new conception to give us a credit on a United States income tax for something in the nature of a sales tax, but I submit it is not quite that. There is no opportunity for these tin producers to pass on a sales tax to the consumer, because our proceeds are solely the Government price that is received.

In the case of some of the miners it is the price that is paid by the Metals Reserve Company, in our case the price that is paid by the British, which, under agreement, has to be the same as that paid by the United States. The net result, of course, is that in the case of the United States company it suffers in its competition as to what it will receive net. Its expenses otherwise are the same. It suffers in its competition with Chilean, English, and other companies who do not have the same tax situation. The decree speaks of the tax as being one upon gross receipts, but the Spanish words for "gross receipts" can equally well be translated into gross profits, and it is often translated that way. But there is no mistaking the fact that that additional tax follows an earlier effort to bolster the Bolivian exchange by requiring a delivery of foreign currency received to the Bolivian Government at an artificial Government rate instead of at the existing bank rate, which meant the miner got just about half value for what he turned in. That was changed, and the tax we are now referring to was worked out by the Government at the percentage rate that would create the same income to the Government though still recognizing the existing bank rate instead of the artificial Government rate as the price to be paid for the currency delivered.

Senator TAFT. Do you have to pay it in English exchange?

Mr. ROYCE. No; we do not pay it in English exchange. We turn back to the Treasury a portion of the English exchange that we receive. Out of that is taken a percentage tax which is charged against us in Bolivian exchange, and we are returned the rest in Bolivian exchange.

Relief to be given companies operating in mining, and they are the bulk of the companies in Bolivia, would have no damaging effect on any United States business. To date there have never been found any appreciable deposits of tin in the United States. The other mining in Bolivia that might be affected is tungsten and antimony. All three are vitally needed.

As suggested in the memorandum, the scope of enlargement of section 131, such as we urge, might well be limited to strategic metals in the manner in which another section of our law lists what the strategic metals are. I am referring only to strategic metals. Neither we nor any other company that I know of operating Bolivian mines in Bolivia, sell any service, product, or anything else in the United States in competition with any United States concerns.

We believe that this would have the support of anyone related to the Government. We believe that there is an advantage in having the biggest tin producer in the world continue to be a United States company.

It was, in a way, an accident that our company started out with a Delaware charter. There was a large public offering of shares in the company made in the twenties, and the bankers suggested that it be a Delaware company. It has never done any business in the United States. It has paid its United States tax bills, returning over 10 percent of net income, with no businses done in the United States up until now.

We consider this unfair and the new rates simply become confiscatory. It destroys our competitive position in Bolivia and hampers increases in production there and it may force the giving up of a United States charter. In relation to South American countries, with

changes in governments, we think the past has shown, and the future will continue to show, that where a United States company is operating there, obeying its laws, performing a service, it is going to be respected possibly a little bit more than companies coming from other countries.

A suggestion might be made that the relief for United States companies might come in a change in the Bolivian tax law. We were given relief to some extent in the provision of the decree that I earlier referred to, which is in the memorandum, but I must say that seems to me hardly appropriate. We have not ourselves yet approached the Bolivian Government on the subject, because this situation arises solely on account of our United States laws and not the Bolivian law.

Bolivia taxes all enterprises conducted in Bolivia. It requires that all foreign companies coming to Bolivia shall be, as they call it, domesticated nationals, so as to be treated, for tax purposes, just as well or just as badly, as the local company. The United States, as far as I know, is the only country that imposes a tax of any substantial amount that has to be added to the Bolivian tax in order to determine the cost of operations of a mining company producing tin in Bolivia.

Senator TAFT. How much difference in money does it make to you? Of course you can deduct the taxes as an expense, you can deduct the expenses as a credit on the taxes. The higher the rate comes the less they pay.

Mr. ROYCE. As applied to last year, the difference between a credit and a deduction would certainly have been in excess of half a million United States dollars in our company alone.

The CHAIRMAN. Mr. Royce, we thank you for your appearance, if there are no further questions.

Mr. ROYCE. Thank you very much.

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

MEMORANDUM OF ALEXANDER B. ROYCE, NEW YORK, N. Y., VICE PRESIDENT AND GENERAL COUNSEL OF PATINO MINES & ENTERPRISES CONSOLIDATED, INC.

Relating to proposed amendment to section 131 I. R. C.

The company which I represent is a Delaware corporation operating tin mines in Bolivia, where it produces about one-third of that country's entire output of tin ores. Under long-term agreement with the British Government, its tin ores are shipped to England for smelting and become an important part of the Allied war effort. Patino Mines & Enterprises Consolidated, Inc., purchases in the United States substantial amounts of equipment for use in its mines in Bolivia. These purchases made in the United States in 1940, amounted to $824,548, in 1941 to $1,354,298, and in the first 7 months of 1942 to $609,531. It does not compete with any domestic company operating in the United States.

On July 28, 1942, Mitchell B. Carroll, Esq., representing the National Foreign Trade Council, Inc., appeared before this committee and proposed, among other things, an amendment of a portion of section 131 of the Internal Revenue Code. In his statements and memorandum to the committee (p. 206 ff. of reported hearings), Mr. Carroll urged his amendment in order to clarify the right to receive credit on United States income tax in the cases of taxes imposed by Latin-American countries on gross income, and he further stated "the allowance of the credit is equally justified where the tax on net income is replaced by a tax imposed on an empirical basis in the case of foreign entrprises which produce or process goods in the country and sell them abroad" (p. 216 of report of hearings).

This statement of the purpose of allowing a credit for taxes so imposed on production and sale outside the United States should lead to the inclusion in his proposed amendment of language that would clearly give the credit in the case

of domestic companies conducting mining enterprises in Bolivia. However, this is not the case because of the nature of the Bolvian tax system, which was not presented to the committee by Mr. Carroll.

It is the purpose of this memorandum to acquaint this committee with the Bolivian tax methods and to urge a revision of Mr. Carroll's proposed amendment, so as to give to enterprises conducted in Bolivia the benefit which he points out should be granted to enterprises conducted in other Latin-American countries.

Since 1923, Bolivia has had a tax on the net profits of mining companies. This tax has been recognized as an income tax which may be taken as a credit against United States income tax (Internal Revenue Bulletin III–2, p. 250).

During the troublesome years which followed 1923, Bolivia, to meet its financial requirements and to support its currency, passed a variety of additional tax laws. Mining, and particularly tin mining, is the principal industry in Bolivia and the principal source of revenue to its treasury. In the year 1939, a Supreme Decree was enacted, under date of June 7, which increased the taxability of mining enterprises and regulated the conduct of the mining business.

By the 1939 decree a tax on profits calculated on gross receipts of the mines was established (art. 16) and an "additional tax" was imposed (art. 14). Under earlier decrees the mining companies were required to deliver to the Bolivian Treasury 42 percent of the foreign currencies received on the shipment of ores, to be exchanged into Bolivian currency at the Government rate of Bs. 82 to the pound sterling in contrast with a bank rate of Bs. 140 to the pound. This 1939 decree provided that the mining companies shall receive Bolivian exchange at the more favorable bank rate, but at the same time taxed them in the amount of 41.43 percent of the exchange delivered. The relevant portions of this decree, as translated in Bolivian periodicals at the time, are as follows:

"* * * Whereas the system at present in practice for the delivery of the exporters' drafts on foreign countries has yielded results which are not in accord with the requirements of the nation, as they show a minimum percentage in favor of the country while private profit increases to a disproportionate extent and is sent abroad;

"Whereas it is necessary to modify the law on mining profits by establishing a simple procedure to prevent falsification of accounts for the purpose of evading the payment of taxes;

* * * * * * *

"ART. 14. For the profit received by the state for difference of exchange, there is substituted an additional tax on the export of minerals, payable in national money, which will be calculated on the part of the foreign exchange delivered which is specified below, and the proceeds will be converted into national money at the banking rate of exchange. This additional tax will be equal to 41.43 percent of the percentages of delivery of foreign exchange which were effected at the rate of Bs. 82 per pound sterling, in accordance with the supreme decrees of June 8, 1937, of October 4 and 31, 1938, and December 23, 1938.

"ART. 15. The payment of this additional tax on exports is independent of the taxes which are at present imposed on exports, such as: Customs dues, statistics dues, additional dues, surplus and extra surplus dues, which will continue to be paid in the form established.

"ART. 16. The mining companies and enterprises, regardless of the form in which they are constituted, will pay a tax on profits, calculated on 30 percent of the gross receipts for the large-scale mines and 20 percent for the medium- and small-scale mines, in accordance with the following scale:

	Percent
Up to Bs. 500,000	8
From Bs. 500,001 to Bs. 1,000,000	8.5
From Bs. 1,000,001 to Bs. 2,000,000	9
From Bs. 2,000,001 to Bs. 3,000,000	9.5
From Bs. 3,000,001 to Bs. 4,000,000	10
From Bs. 4,000,001 to Bs. 5,000,000	10.5
From Bs. 5,000,001 to Bs. 6,000,000	11
From Bs. 6,000,001 to Bs. 7,000,000	11.5
From Bs. 7,000,001 and over	12

"ART. 17. By gross receipts are understood the amounts obtained by the mining companies from the sale of their products, calculated at the banking rate of exchange, from investments, interest, company stores, and any other income arising from subsidiary industries."

(Subsequent changes were made in the rates, under articles 14 and 16.)

On June 14, 1941, the Bolivian Government decreed as follows:

"The large mining companies subject to double taxation abroad on profits, deductible from the ones paid in this country, shall pay the tax according to November 30, 1923, law and its regulations, if by it results a higher income from the Treasury than if the June 7, 1939, decree on gross income were applied."

In the case of the company I represent, the result of this June 14, 1941, decree is that it pays as an income tax, with credit in the United States, a part but not all of the amount of the taxes (tax on gross income and additional tax) imposed by the June 7, 1939, decree. It would seem clearly equitable that credit for the full amount should be availabe without the distinction as to type of tax which is required by the retention in section 131 of the limited United States conception of income tax.

But a change in section 131 which will add the credit only in the case of taxes imposed "in lieu of" income tax, might actually take away, rather than enlarge, the credit allowance now available to domestic companies mining in Bolivia. Therefore, to meet this Bolivian situation, it is imperative that the language of Mr. Carroll's proposed amendment be revised. The following changed language is suggested:

"SEC. 131 ( ). For the purposes of this section the term 'income, war-profits, and excess-profits taxes' shall include taxes imposed upon or measured by gross income, or upon the export of minerals and the proceeds thereof, which are imposed in addition to or in substitution for a tax on net income allowable as a credit under this section, provided the taxpayer proves to the satisfaction of the Commissioner the amount of net income allocable to sources within the foreign country in accordance with the requirements of subsections (b) and (e) of this section."

The Bolivian tax payments for which a credit will be permitted under my proposal are made out of the proceeds of mining strategic metals (particularly tin ores) which are not produced in the United States, and are urgently needed by the United States and its Allies. The scope of this change might appropriately be limited, if so desired, to "strategic metals" as presently listed in section 731 of the Internal Revenue Code. It is such strategic metals which are produced in Bolivia and shipped out of that country.

It is important to realize that the change I propose should encourage the further development of Bolivia's output of strategic metals. Bolivia has broken its relations with the Axis Powers and, therefore, its output is exclusively available to the Allies.

As applied to the company I represent, the relief requested appears clearly to be merited and could be granted without damage to any United States interests. Patino Mines & Enterprises Consolidated, Inc., does not mine, produce, market, or furnish any product or service in competition with any companies or interests operating in the United States. No tin ore deposits of importance have yet been discovered in the United States. It seems to us to be in the national interest that this biggest tin producer in the world should continue to be a United States company, even though its operations of necessity are located outside the United States, and that it should be encouraged to continue as a United States corporation and to expand its production.

Respectfully submitted.

ALEXANDER B. ROYCE.

Dated: NEW YORK,
August 5, 1942.

The CHAIRMAN. Mr. Rothschild.

STATEMENT OF MEYER D. ROTHSCHILD, NEW YORK, N. Y.

The CHAIRMAN. Go ahead with your statement, Mr. Rothschild.

Mr. ROTHSCHILD. My name is Meyer D. Rothschild; address, 6 West Forty-eighth Street, New York City.

I retired from business 20 years ago, and am appearing on my own behalf to explain a form of sales tax which, I feel convinced, would produce a large amount of money at a tax rate not exceeding 1 percent.

To conserve your valuable time, I shall be brief, relying partly on the statement I made to the House Ways and Means Committee on

April 8, reported on page 2225, volume 3, of the Revenue Revision of 1942 hearings before that committee. In order to make my plan clear it is necessary that you should have a copy of the statement made before the Committee on Ways and Means. I request permission to have that statement printed in the record in connection with the statement I am making now.

Should a sales tax be seriously under consideration as part of the 1942 Revenue Act, I respectfully submit that the only kind of a sales tax which can produce substantial revenue at a very low rate, namely, 1 percent, is the gross sales, or turn-over, tax which had Nation-wide consideration 20 years ago, and which was then approved by businessmen in every part of the country.

The details of that approval will be found in a study I made in 1935 comparing the then proposed manufacturers' tax of 1932 of 2¼ percent with the gross turn-over tax of one-half of 1 percent. This study, consisting of 95 typewritten pages, was undertaken at the suggestion of the late Mark Graves, president of the New York State Tax Commission, a copy of which will, with your permission, be filed with the clerk of this committee for the convenience of those committee members who may be interested.

May I file that?

The CHAIRMAN. Yes.

Mr. ROTHSCHILD. I should also like to file a tax primer containing 107 questions and answers on the turn-over tax which was published in 1920 by the Business Men's National Tax Committee.

The CHAIRMAN. Yes, sir.

Mr. ROTHSCHILD. I will do that.

The gross sales, or turn-over, tax covers not only a tax on goods, wares, and commodities, but on all business and service transactions as well. Notwithstanding the general belief to the contrary, the turn-over tax can be administered with a much smaller force of field agents than the manufacturers' or the retail-sales tax. A manufacturers' tax is payable on sales by a manufacturer, producer, or importer, but it has not been possible in many cases in the past to determine when a taxpayer is a manufacturer in the usual understanding of that term. In fact, where it has been supposed there were only scores or hundreds of manufacturers in an industry there have been hundreds or thousands of "producers" subject to the manufacturers' tax. The Internal Revenue Department has always considered the word "producer" synonymous with "manufacturer," and has gone as far as to decide that the placing of two articles together, which did not involve any work in excess of simply joining them by hooking one on another or placing one within the other, to be an act of manufacturing.

An effort was made by the advisors to the Committee on Ways and Means and the Treasury to so frame the 1932 manufacturers' tax that it would be workable, but the result of their efforts was a bill which was in every way impossible of fair administration from a business point of view.

The turn-over tax would not necessitate engaging the services of an additional number of revenue men to check this tax for the following reasons:

A. There is no way to avoid the tax because every sale or transaction is subject to the tax without exception, and the only deduction

the taxpayer is entitled to make is tax paid on a previous transaction which did not materialize.

B. Tax evasion is only possible if the taxpayer deliberately falsified his books which nobody would do to evade a 1 percent tax which could be passed on to the purchaser.

C. In short in the vast majority of cases a glance at the taxpayer's sales book shows his tax liability. No question can be raised by the taxpayer or the revenue agent as to whether a sale is taxable or not, as all sales are taxable without exception.

Compare this condition with the numerous questions which arise under retail-sales taxes, the principal one being, "when is a particular sale a 'retail' sale?" In considering any sales tax the certainty of classification and ease of administration are paramount, and in those particulars the turn-over tax stands out as the only sales tax which is both avoidance and evasion proof. Any doubt on this important point can be solved by reference to the Sales Tax Division of the Revenue Department.

Under the acts of 1918 and 1921 the goods of a certain industry were taxed at 5 percent on sales for consumption or use. In the course of time complaints were made that some of those goods were sold by other industries without the payment of any sales tax. This went on for some years until finally representatives of the taxed industry arranged with the Sales Tax Division of the Revenue Department to assist in making an investigation. Competent men canvassed dealers who were selling the taxed goods in some 20 cities in different parts of the country having from 2,000 to 500,000 inhabitants.

This investigation consisted of reporting by name and address dealers who were then selling some of the goods covered by the Revenue Acts of 1918 and 1921, which were identical with the goods under consideration. The result of the 1,500 cases reported from about 20 cities from different parts of the country were astounding.

The deputy tax commissioner in charge of sales reported that over 50 percent of all the names submitted had never made a sales-tax report in 5 years. When the industry offered to continue the investigation the deputy stated that he was convinced that those sample reports represented the condition throughout the country. The loss to the Treasury was substantial as was the injury to honest dealers who suffered from unfair competition. This could not have happened under a turn-over tax, as the entire sales of every dealer would be taxable.

Corporations which do not show net income are not obliged under our profit system to pay taxes, yet they enjoy all the benefits which the corporations showing net income do. Reference is made to this condition in my statement to the Committee on Ways and Means for the period of 10 years from 1920 to 1929. The period from 1931 to 1940 shows that at 1 percent $3,700,000,000 could have been collected from corporations which showed no net income and therefore paid no taxes.

The 1937 gross income of all corporations showing net income was $109,000,000,000, and those showing no net income $33,000,000,000, or a total of $142,000,000,000. A turn-over tax of 1 percent would yield $1,420,000,000, which could be passed along by the seller in whole or in part as he saw fit.

The corporations showing no net income and now paying no taxes could not complain of a tax which, if and when it was desirable, they could pass along to their customers as tax.

Much attention has been given in the past to the supposed heavy burden which a sales tax would place on taxpayers who lacked ability to pay. This might be true in the case of a 5- or 10-percent retail sales tax, but can hardly be maintained in the case of a 1-percent turn-over tax.

While 1 percent would be the amount the purchaser would pay on all purchases, the tax content of a purchase of goods, wares, and commodities would, on account of the pyramiding from raw material to finished product (if all the taxes were passed along), amount to about 3 percent in the final price. All other turn-over taxes such as rent and services do not pyramid, so it might fairly be said that in spite of the pyramiding—all of which inures to the Treasury—the taxpayer would rarely have more than 2 percent as the tax content of his purchase or payments by reason of the 1 percent gross turn-over tax.

In opposing a sales tax political stress is generally laid upon the unfairness of imposing a tax which would bear unfairly on the very poor because the tax would be on bread, milk, meat, all other articles of food, clothing, and so forth. This objectionable feature is greatly reduced under the 1-percent gross sales or turn-over tax through following the example of the city of New York in the successful administration of its emergency tax originally 2 percent and now reduced to 1 percent. There is no tax whatever on the first 24 cents of any one sale, but from 25 cents to $1.39 the tax is 1 cent; $1.40 to $2.39 the tax is 2 cents; $2.40 to $3.39, the tax is 3 cents; $3.40 to $4.39, the tax is 4 cents, and on each additional dollar or fraction thereof, 1 cent plus the above rate.

This schedule makes it possible for a thrifty housewife to buy most articles of food for 24 cents or less and many other articles without the payment of any tax, while the seller pays the full amount of the tax to the Government, as his tax liability is based not on individual sales but on his gross sales for the month or any other period provided by the law.

This practically relieves low-income taxpayers from the turn-over tax on most of the purchases of food and many other articles, while 1 percent on the balance of the expenditure of every kind comes to less than $10 annually where the tax is on every outlay other than food on an income of approximately $1,200.

To quote Dr. Thomas S. Adams, tax adviser to the Treasury Department, in an article published in the New York Evening Post, he said of the general turn-over tax:

> The most inclusive—the general turn-over tax—has, I believe, no chance of adoption. Its yield at 1 percent would be enormous, if not the $5,000,000,000 which have been claimed for it, certainly $2,000,000,000 a year at 1 percent.

This estimate by Dr. Adams was made in 1920 on the then turn-over of the country. How much would today's turn-over produce?

The turn-over tax is not a new idea but one that has been studied and understood by the businessmen of the country, and on the referendum No. 36 of the Chamber of Commerce of the United States 265 chambers of commerce and boards of trade voted for such a tax.

Nothing then stood in the way of its adoption but the political slogan that the tax was unfair although some politcians admitted that the turn-over tax being a lieu tax would be the lesser burden.

If this turn-over tax should form part of the 1942 tax bill it might even be possible to give the small taxpayer some relief, which would still further reduce his additional payment of the 1 percent war tax and leave him more money for the purchase of War bonds and stamps.

The CHAIRMAN. Thank you very much.

Mr. Friedman.

STATEMENT OF ELISHA M. FRIEDMAN, NEW YORK, N. Y.

THE CAPITAL-GAINS TAX

Mr. FRIEDMAN. My name is Elisha M. Friedman, of New York. I am a consulting economist and appear now in the public interest, on the taxation of risk taking, the so-called capital-gains tax, as I have previously appeared before the Senate Finance Committee on H. R. 9682 in March 1938, and on H. R. 5417 in August 1941, and before the House Ways and Means Committee on proposals for H. R. 7378, in March 1942.

The briefs before the House committee contain the most extensive array of Government statistics ever assembled on the question of the risk tax or so-called capital-gains tax. The facts are all there. I shall not take your time to repeat this mass of data, but give you now a verbal summary. In adition, if you will permit me, I shall file a brief embodying the important features of the data submitted to the House committee, modified in the light of the terms of the House bill.

The House bill, H. R. 7378, provides:

(1) A single holding period of 15 months, in lieu of the two holding periods of 18 months and 24 months of the present law, thus distinguishing between so-called long-term capital gains and losses.

(2) Short-term gains are subject to the regular income tax.

(3) As for long-term gains, one-half is regarded as net income, and is subject to the regular income tax; but a maximum rate is set of 25 percent on net gains in place of the 15 percent and 20 percent now in effect.

(4) Losses, either short-term or long-term, may be offset against gains, either long-term or short-term, thus abolishing the meaning of the holding period.

(5) Losses, long-term or short-term, may not be deducted from regular income, except up to $1,000.

(6) Losses may be carried forward for 5 years and applied against gains subsequently realized. Such carried-forward losses may also be deducted from income up to a limit of $1,000 in each year.

The terms of this bill will make it fail as a revenue producer.

PROVISIONS PROPOSED

May I respectfully urge that the provisions of the bill sponsored by the late Representative Patrick J. Boland be adopted by the Senate Finance Committee as a sound tax on capital gains and losses? I think

the title of this tax ought to be changed from a "capital-gains tax" to a "capital-risk tax," for that is precisely what the tax is. It is a tax on risks.

The provisions which I respectfully submit for your consideration are:

(*a*) Eliminate the holding period.
(*b*) Segregate capital gains and losses from regular income.
(*c*) Restrict deductions of losses to segregated gains.
(*d*) Set a 10-percent rate to produce increased revenue.
(*e*) Carry losses forward 3 years.

Revenue produced.—If the holding period is eliminated there would be no distinction between long-term gains and short-term gains. The low rate would be a straight tax. All the short-term fluctuations would thus become sources of revenue for the Treasury.

There are abundant Treasury data to support the conclusion that such tax would produce $200,000,000 to $600,000,000 revenue in a year. The present capital tax produced only $12,000,000 of revenue in 1940, during which year the value of New York Stock Exchange securities fluctuated 10.3 billion dollars net and 48.4 billion dollars gross. The cost of collecting it probably exceeded $12,000,000. The tax produced 0.1 percent of the net fluctuation and 0.02 percent of the gross fluctuation. The Federal stock transfer tax is about 0.33 percent of the market value.

No tax on capital risk abroad.—There is no tax on capital gains in Great Britain and Canada. Great Britain has had an income tax since 1842. A Royal Commission studied the capital-gains tax and Parliament rejected the capital-gains tax as a revenue source.

There was no capital-gains tax in France, Holland, Belgium, Denmark, and Norway until the Nazis invaded these countries. But even the capital-gains tax introduced there afterward is mild compared to the Treasury proposals. The tax originally introduced in France by the Vichy Government in March 1941 was 33 percent, regardless of the holding period. The experience was disastrous. Securities prices sky-rocketed. Government by decree moves rapidly. Successive and frequent modifications limited the holding period to 12 months and then reduced it to 3 months, and the rate from 33 to 20 percent and then to 10 percent. The French capital-gains tax since February 1942, is 10 percent on securities sold within 3 months. There is no tax thereafter. Real estate, farms, and all other assets except securities are exempt.

The House bill, H. R. 7378, embodies substantially the Treasury suggestions. However, the Treasury submitted no estimate of increased yield, or even of any yield, from its proposals on the capital-risk tax. This is unique. It did so for every other tax proposal. But Treasury reports covering previous years do furnish abundant evidence that the House bill H. R. 7378 will decrease revenue rather than increase it.

Analysis of capital gains provisions of H. R. 7378.—1. Hitherto the law made a distinction between long-term and short-term holdings. The House bill now provides that long- and short-term losses be treated alike in offsetting either type of gain and alike in being nondeductible from income except up to $1,000. Thus the bill at

one swoop abolishes the distinction between long- and short-term gains. Yet, at the same time the bill amazingly does a right-about-face and provides that a 15-month holding period distinguish long-term gains from short-term gains. Is this not inconsistent and illogical?

The holding period is thoroughly artificial; a figment of the imagination. The mere fact that the lengths of the holding period have, in the revenue laws of the past decade, been shifted from 1 year up to 10 years, and are now being shifted from 24 months to 15 months, indicates that no one knows what a "holding period" really means. Is the "holding period" a mere subterfuge to justify taxing the so-called short-term gains at income tax rates?

2. The bill provides that long-term losses should no longer be deductible from income as heretofore. This theory is correct. Long-term losses are put into a different category from income. Therefore, why does the House bill now propose to raise rates on long-term capital gains merely because it proposes to raise rates on income?

3. The House bill provides for the reduction of the holding periods from 24 months and 18 months to 15 months. The 15-month period is harmful to our war finance.

In the current rapid movements of world history, how few can take a commitment for 15 months? The Treasury says it is on a 24-hour basis. Is it fair to expect the investor to be on a 15-month basis? The revenue-producing factor is not the shorter holding period, but the lower rate.

Besides, we need planes, tanks and guns now, not 15 months from now. The tax that the Treasury may collect, if the market stays up for 15 months, is of less value than the tax that the Treasury will surely collect on short swings in the market today, tomorrow, every day, if the holding period is abolished.

4. The House bill, H. R. 7378, provides a 5-year carry-over. Such a provision, though very welcome to the taxpayer, would virtually destroy potential revenue for the Treasury. From 1917 to 1940, for the country as a whole, there was only one 5-year period, 1925–29, which showed net capital gains for every year of the period; of the remaining 19 years, 13 showed net capital losses. Most periods of 5 years showed net losses.

5. The House bill provides a maximum rate on long-term capital gains of 25 percent. Why was a 25-percent rate set? Is it to produce revenue?

Official figures prove that a 25-percent net rate never produced revenue in the past, and probably never will in the future. In 1938, for example, the $50,000 income bracket paid a surtax rate of 30 percent on short-term gains, but long-term gains were taxed at the 15-percent rate. What does the official record show? Gains under the 15-percent rate were over $20,000,000, or three times as great as the $6,600,000 gains under the 30-percent rate. What evidence is there to prove that the situation will be different in 1942?

An even more sensational demonstration is available from the statistics for 1934. On the incomes of over $100,000 the 33-percent rate on holdings of 2 to 5 years produced $138,000 but the 16-percent rate on holdings over 10 years produced over $34,000,000. Of the total

capital gains taken on $100,000 incomes over 70 percent was taken at the 16-percent rate.

There is a progressive decline in capital gains taken as the tax rates rise. In the holding period, 2 to 5 years, in 1934 the amount of capital gains taken at the 33-percent rate of the $100,000 bracket was the lowest of any income bracket. The average 13-percent rate of the $25,000 to $50,000 bracket produced 24 times as much, and the average 6-percent rate of the $5,000 to $25,000 bracket produced 68 times as much.

The present apathy of the Nation's stock markets and the low volume of transactions are an illusion that all income brackets are equally inactive. If one analyzes stock transactions in the light of the Treasury returns, it is evident that for the big investors and stockholders the stock market is virtually closed today.

In 1938, 48 incomes in the top brackets of over $1,000,000 took short-term gains of $3,600 each. Thus the Government gets no revenue and the stock market is closed to the large investor. And the S. E. C. worries about being blamed. What a field for action by the S. E. C. It frames elaborate 7-point plans to save the 21 stock exchanges from extinction and overlooks the most important. Let the S. E. C. back the Boland bill as the I. C. C. endorses tax provisions to help the sick railroads.

Capital is idle.—The capital-gains tax is a lock-out order. Only the smallest people can now speculate. The big stabilizers of the market are out. Therefore the volume on the stock exchange is insignificant. Therefore the market is without leadership—erratic, swinging extremely at tops and bottoms, and without any courageous anticipation of events.

The Government's published data afford no evidence that the capital-gains provisions of H. R. 7378 would be useful, practical, or revenue-producing. Capital gains are the folklore of public finance, shrouded in mysticism. Capital gains are fiscal follies—bipartisan buncombe for 25 years.

Wild inflation would result.—The House bill, H. R. 7378, will, if enacted, probably cause a wild inflation in real estate, farm land, and securities. The proposed high rate of tax on long-term gains and the prohibitive rate on short-term gains place a penalty on the seller but none on the buyer. The House bill would thus create a one-way market.

If the market should consist mostly of buyers with few or no sellers, it would repeat on an aggravated scale the experience of 1929 and 1932. A buyer's panic would ensue. Stock prices would skyrocket. This is exactly what happened in Vichy, France, under the capital-gains tax rate of 33 percent imposed in March 1941.

The capital-gains tax deterred Americans from selling in 1928 and 1929. The main European stock markets—London, Paris, Amsterdam, Brussels, and so forth, were free of a capital-gains tax. All these markets turned down beginning with the spring of 1928 to January 1929.

The American market, restrained by a capital-gains tax, carried on the rise into the autumn of 1929 at an excited, hysterical speed. Then came the collapse, which ran for 3 years into the summer of 1932. The

Dow-Jones industrial index of American shares declined to one-tenth of the 1929 peak levels, but European shares to one-half or one-third only. The collapse of the American market brought in its train world-wide unemployment, social disturbances, the rise of Naziism, and then the war. Of course, the capital-gains tax was not the sole factor in this sequence of events, but it was an important contributory factor.

It takes no prophet to predict that the coming boom in property and the coming collapse under the proposed restrictive capital-gains tax will exceed by far that of the period of 1929 to 1932. Let the Senate Finance Committee consider carefully provisions on capital gains of the House bill. How grave is the responsibility for wise action? Should not the Senate Finance Committee revise the capital gains tax in the light of official statistical data and official factual evidence?

Analysis of criticism of proposed provisions.—Let us now turn from the House bill on capital risk to the criticism of the provisions of the Boland bill which should be adopted by the Senate Finance Committee.

1. It is argued that the "Boland bill would abandon the principle of ability to pay with respect to capital gains of individuals."

The figures for 1917 to 1940 compiled by the Division of Tax Research of the Treasury and only recently released for the latter years refute the notion that capital gains are regular or recurrent or represent the capacity to pay. Excluding the 5 years 1925 through 1929, the 19 other years show total capital gains of 12.8 billion dollars, losses of 21.1 billion dollars, or net losses of 8.3 billion dollars, an average net loss of $474,000,000 per annum, even excluding the nondeductible short-term losses.

Why should we enact legislation on an assumption that not only has never been supported by statistics but has been strikingly contradicted? As Samuel Johnson said: "Experience becomes the great test of truth and is perpetually contradicting the theories of men." Experience dissipates error.

2. It is said further: "The Boland bill would eliminate the very real and equitable distinction between short-term and long-term capital gains." Bill H. R. 7378 provides that the difference between long-term and short-term holding be eliminated. Long-term losses and short-term losses are treated alike in being deductible from either long-term gains or short-term gains.

In fact, though the bill sets up a 15-month dividing line, long-term and short-term gains are alike. Here, indeed, is a distinction without a difference. The Vinson Report to the House committee in January 1938 admitted that any distinction is arbitrary. Under the newly proposed income tax brackets taxpayers might pay 82 percent on short-term gains taken in 14 months and 29 days and then pay 25 percent on long-term gains taken in 15 months and 1 day—only 2 days later. What logic can justify such a proposal?

3. Another argument runs: "The Boland bill would place a premium on speculation as a way of securing a living." A speculator makes money only if he sells securities when they are high and buys them when they are low. Unfortunately, almost everybody does the reverse. The theoretically ideal speculator would perform a very great public service, but he is all too rare. How successful he would be as broker or

investment counselor. Speculation as a way of life is notoriously uncommon. The law should encourage, instead of punish, such stabilization operations.

4. Again it is argued: "The Boland bill would favor a relatively small group of high income bracket taxpayers." Why would it favor this group? Every Treasury table published for over 20 years shows that taxpayers in the high brackets take little or no short-term capital gains. Therefore, the Treasury receives little or nothing. A low rate like 10 percent would produce revenue. If getting people to pay a tax is "favoring" them, let's do a lot of "favoring." The Government needs revenue.

May I cite some very startling facts about millionaire incomes in 1938. As shown above, 48 taxpayers reporting incomes of over $1,000,000 in 1938 had short-term gains of only $175,000, or an average of $3,600 each. The million-dollar incomes in 1938 did very little speculating for the short term. Indeed, as incomes rose in the tax brackets short-term gains of 1938 constituted an ever-diminishing percentage of total income.

Is it socially useful or economically desirable that those best able to undertake the risks of stabilizing markets should be prohibited from doing so? Should those least able to take the risks be encouraged to do so? Is it logical to impose a capital-gains tax and then set rates so high as to prevent the Government from obtaining revenues therefrom?

To raise the income surtax rates to 82 percent and then to create the artificial classification of short-term gains, so as to furnish an excuse to tax them as income, is a sure way not of producing revenue but of preventing revenue; not of punishing a small group of high-income-bracket taxpayers, but of punishing the Treasury and punishing the other taxpayers who must take over the burden of such fiscal errors.

It was stated publicly that the Treasury would rather be short $2,500,000,000 rather than enact a sales tax. From the point of view of revenue, this attitude seems of doubtful wisdom. However, as a political move it can be understood. Though the Gallup polls show that a majority of the public favors a sales tax, yet the failure to levy a sales tax may placate some organized minority groups.

Who is to be placated when so-called short-term gains on risks are taxed up to 80 percent and more, and long-term gains on risks are taxed up to 25 percent? What group in the community can conceivably bring pressure for such a move? What group has done so? Is it then worth appeasing an imaginary, non-existent ghost group and to forego additional revenue of from $200,000,000 to $600,000,000 a year at a time when the Government sorely needs revenue? Such a course is devoid not only of fiscal realism but even of political wisdom. What a price to pay for a policy of potential placation.

5. Another argument reads: "The Boland bill would open the road for tax avoidance," by lowering the rates of tax on capital gains. But every table and chart based on Treasury figures proves the opposite.

High capital gains taxes check selling and taxpaying. This was stated in H. R. 9682, the revenue bill of 1938, in the report of the House Ways and Means Committee. "He (the taxpayer) can avoid the tax by refraining from selling." The House bill ignores this kind of tax avoidance.

6. The final argument runs: "The Boland bill would provide an excessively low rate of taxation." Is it low? Let us regard the capital gains tax as a sort of transfer tax. A 10 percent rate on capital gains for the privilege of transferring from one security to another is terrifically high when compared to the transfer tax now in effect. This amounts to 0.25 to 0.33 percent of the market price. Yet these rates of transfer tax yielded $12,000,000 in revenue to the Treasury in 1940. But in 1940 the high rates of capital-gains tax, including a 77 percent tax on short-term gains, brought likewise only $12,000,000.

To quote Horace: "The mountains were in labor and brought forth a mouse."

Court decisions.—As shown by Godfrey N. Nelson in a paper at the Duke University Law School capital gains were declared not taxable as income by the United States Supreme Court in 1872: "Mere advance in value in no sense constitutes income * * *. It constitutes merely increase of capital." In 1915 a United States district court decided likewise and the Court of Appeals upheld it. Only in 1918, when the Government sorely needed revenue for war purposes, did the Supreme Court reverse this decision and hold capital gains to be taxable. The motive was revenue. However, official statistics prove that high rates of capital-gains tax hitherto applicable have not produced worthwhile revenue.

Revenue is a trifle.—According to Treasury figures, the capital-gains tax revenue averaged $31,200,000 in the decade 1931–40, about $26,000,000 for the 11 years 1930–40; about $20,000,000 for the 2 years 1939–40; and about $12,000,000 for the year 1940. Treasury figures should show probably zero for the year 1941. If the abnormal year 1936 is eliminated, the remaining 10 years of 1930–40 showed average revenue of $9,000,000. The yield would have been even less had not the Government improperly limited deduction of short-term capital losses.

On the other hand, the low rates of 0.25 to 0.33 percent of the stock transfer tax average annually about $23,200,000 for the same decade. In 1931, 1932, and 1933 the Government lost $184,000,000 in tax revenue through deduction of capital losses from the income tax. But in the same 8 years the stock transfer tax provided $76,000,000 of tax revenue to the Government. It never showed a loss to the Treasury. It never befuddled markets. It was simple to administer and to collect. What more striking evidence that a high rate on capital-gains tax is unproductive, complicated, and pernicious compared to a low tax rate, as in stock transfers?

Capital gains are illusions at which doctrinaires clutch. Twenty-five years of experience shows that it produces little or no revenue, that it prevents shifts from one security to another, even into United States Defense bonds. Under this illusion the Treasury has seen potential taxes appear and vanish, like the farmer watching a crop grow and rot.

This illusion has created unstable and hysterical markets in 1929 and 1937; in 1932 and 1938. This illusion is one of the most vicious fiscal concepts that ever afflicted a nation. It brought no benefits. It wrought much evil.

War and post-war aspects.—Troubled times face us after the war. American economic life must be rid of this illusion if the country is to face its problems realistically. This illusion should be extirpated from American public finance. The capital-risk tax has no place in our fiscal system.

But the Government needs revenue in wartime. A Senate bill containing the provisions of the Boland bill will exploit the revenue-producing possibilities of the capital-gains tax. Should not the Senate committee frame a bill based on official statistics as the Boland bill was? Should it not be enacted into law for the duration of the war?

The law would also benefit real estate and stores in the 21 cities having stock exchanges and having a total population of over 20,000,000. It would indirectly benefit 43,000,000 workers in industry and 10,000,000 farmers and workers in agriculture. How potent, for weal or woe, is the decision of the Senate Finance Committee now!

The assets of a country are not merely the coal and the copper in the ground. The natural resources are more evenly distributed throughout the world than is indicated in statistics of production, as was stated by Dr. Kirtley F. Mather, professor of geology at Harvard University, to the American Philosophic Society. Man's response determines whether the natural resources will be developed.

A nation's assets include the energy and initiative of its businessmen. We have a program for the conservation of our natural resources. We protect the soil against erosion and draining into the ocean. A tax system can erode and drain away the initiative and energies of men—the most precious natural resource we possess.

At the House hearing Representative Disney, of Oklahoma, stated:

> I should like to make this observation, Mr. Chairman. Mr. Robertson said to me privately awhile ago that when the committee gets into the subject of capital gains we get into a fog. It seems to me that it would not be a bad idea for a subcommittee of two or three members to try to get to the bottom of this subject for the benefit of the rest of the members of the committee.

The Committee on Finance may be already convinced by the avalanche of statistics supporting the terms of the Boland bill, H. R. 6358, and destroying all the assumptions on capital gains in the House bill, H. R. 7378. If the committee is not convinced, may I respectfully suggest that perhaps your committee may find Representative Disney's suggestion of value?

Such a subcommittee of the Senate Committee on Finance would, on study, realize that there are abundant statistics to support the provisions urged above. The bill on taxing capital gains introduced by the late Hon. Patrick J. Boland might well form a sound basis for a tax on capital risks, which would be productive of revenue, would unfreeze the securities markets, and revive the spirit of enterprise now rapidly withering.

Senator TAFT. Is 10 percent and only a 3-months' waiting period the Boland bill?

Mr. FRIEDMAN. The Boland bill had no holding period at all. I think that is the heart of the bill. If you want revenue you have got to remove the holding period. You would then get 10 percent on every trade that is made. The longer the holding period the smaller is the amount that you can possibly get.

Senator TAFT. You heard Mr. Schram?

Mr. FRIEDMAN. Yes.

Senator TAFT. He evidently more or less agrees with you, but he thinks 6 months and 15 percent is about as much as he can hope for.

Mr. FRIEDMAN. It seems to me you ought to eliminate the holding period entirely. As Senator Connally indicated, the important thing is not the rate but the holding period. Providing no holding period and setting a higher rate is preferable to providing a holding period and a lower rate, for revenue purposes. There are abundant Treasury data to prove that such a bill will give you from $200,000,000 to $600,000,000 a year. The interesting omission to note is that the Treasury never submitted an estimate of yield on its proposals for the capital-gains tax, which in substance constitute H. R. 7378.

Senator TAFT. Cutting out the waiting period altogether, taking 10 percent on gains and not taking off any losses at all, how do you think that would work out?

Mr. FRIEDMAN. If you do not permit any offset of losses you should make the rate lower than 10 percent. You would get an enormous amount of revenue. You can figure that out very quickly.

In an average year the New York stock market moves over a range of $10,000,000,000. Assume that half is up and half is down. That gives you $5,000,000,000 on the up move. Ten percent on $5,000,000,000 would give you $500,000,000, you see. It would give you abundant revenue, but I do not know how fair it would be to prohibit offsetting losses.

Senator TAFT. That is not an objection from our standpoint, if we get a lot of revenue.

Mr. FRIEDMAN. May I say that if you wish to carry out the principle of taxing gains without deduction of losses, a lower rate than 10 percent would be necessary, say 3 percent. Such a rate would be more like a transfer tax. But even 3 percent would yield about $150,000,000 per annum. This tax yield compares with actual yields of the capital-gains tax of $12,000,000 in 1940, and an average of $9,000,000 in the period 1930 to 1940, excluding the grossly abnormal year 1936.

May I thank the committee for its patience in hearing this technical statement.

(The following supplemental statement was submitted by Mr. Friedman:)

SUPPLEMENT TO STATEMENT BY ELISHA M. FRIEDMAN, OF NEW YORK, N. Y., ON CAPITAL-GAINS PROVISION OF REVENUE BILL, H. R. 7378

I. ANALYSIS

(a) *A 6 months' holding period too long now.*—It is reported that the Senate Finance Committee would support a proposal on the capital-gains tax whereby the holding period would be reduced to 6 months. In the midst of the uncertainties of a world war the 6-month holding period seems too long. The holding period should be eliminated for investors, occasional buyers, and the general public, but not for professional traders and speculators.

In the Senate Finance Committee hearings on the Revenue Act of 1938, H. R. 9682, when the writer presented a comprehensive statistical analysis on the capital-gains tax as a revenue measure he suggested elimination of the holding period but as a temporary compromise suggested also a 6-month holding period, because a 6-month period was defined as the period for a trading turn under the Securities Exchange Act of 1934, section 16 (b).

TABLE I.—*Surtaxes in 1938 and 1942 (H. R. 7378)*

Income brackets, nearest—	Surtax rate		Income brackets, nearest:—	Surtax rate	
	1938, H. R. 9682	1942, H. R. 7378		1938, H. R. 9682	1942, H. R. 7378
	Percent	*Percent*		*Percent*	*Percent*
$5,000	4	20	$50,000	27	63
$10,000	6	28	$100,000	55	77
$20,000	13	46			

(*a*) *Recent economic changes.*— However, conditions have changed since 1938, and tax laws should be changed to suit the new situation. Then we were at peace, now we are at war. Then it was possible to anticipate 6 months' developments, now it is impossible to look more than a few days ahead. Who foresaw Pearl Harbor, even by 1 hour? In 1938, income-tax rates applicable to short-term gains were relatively low, less deterrent to selling and less disturbing to the market. For 1942, income-tax rates will have been raised sharply. In 1938, prices of commodities and shares were being deflated. In 1942 a price inflation threatens, so high officials warn. The fictitious rise in values will be aggravated if sellers are checked by a high tax. This rise will be restrained if selling is encouraged or unchecked. Any considerations that may have justified taxing short-term capital gains at income-tax rates in 1938 have become invalid or even reversed by 1942.

When rates on short-term capital gains are thus raised, who will take a risk against such odds?

The proposed compromise on a 6-month holding period will produce no income, because the very high income-tax rates in H. R. 7378 would apply within that period. Official statistics for 1938 show how rapidly short-term gains decline as income-tax rates rise.

TABLE II.—*Decline in short-term gains as income-tax rates rise*

Net-income classes	Ratio of short-term gains to total income [1]	Ratio of short-term gains to long-term gains [1]	Surtax rates at top of each income-tax bracket [2]	
			1938	1942
	Percent	*Percent*	*Percent*	*Percent*
Under $5,000	0.34	151	4	20
$5,000 to $10,000	.92	130	6	28
$10,00 to $25,000	1.27	91	17	52
$25,000 to $50,900	1.35	68	27	63
$50,000 to $100,000	1.18	32	55	77
$100,000 to $150,000	1.11	18	58	79
$150,000 to $300,000	.65	6	64	82
$300,000 to $500,000	.27	1	68	82
$500,000 to $1,000,000	.21	1	72	82
$1,000,000 and over	.16	.3	75	82

[1] Source: U. S. Treasury Statistics of Income 1938, table 4, p. 10.
[2] Rates provided in H. R. 7378.

Note that during 1938, in the income bracket $10,000 to $25,000, the ratio of short-term gains to long-term gains was 91 percent. This confirms purely theoretical calculations, because the rate of tax on long-term gains was 15 percent and the rate on short-term gains, namely, income-tax rate, was 17 percent ($\frac{15}{17}$=90 percent). If a narrower range of income had been recorded showing an income-tax rate of 15 percent and capital-gains tax of 15 percent, the ratio of short-term gains to long-term gains should be 15 : 15, or 100 percent. This would confirm the conclusion the volume of capital gains depends on the tax; high rates produce little, low rates produce much.

(*c*) ***Any holding period prevents revenue.***—Under House bill H. R. 7378 increases in income taxes are so sharp that the Treasury will receive even less revenue than is shown in the 1938 statistics for the upper brackets. Indeed,

under H. R. 7378 unproductive rates on capital gains have been extended to the lower brackets. Comparing the income-tax rate on short-term gains in 1938 with the provisions of the House bill, H. R. 7378, one finds how strikingly the rates have risen. Approximately the same surtax rates on income taxes on short-term gains would apply:

Under H. R. 7378 to 1942 incomes of—	Under H. R. 9682 to 1938 incomes of—	Approximate surtax rates
		Percent
$100,000	$1,000,000	75–77
50,000	300,000	63–64
25,000	100,000	52–55
10,000	50,000	27–28
5,000	25,000	17–20

In other words, the nonproductive brackets would now include more taxpayers in the lower-income groups who used to realize capital gains freely. Therefore the Treasury will get even less revenue than the petty sums collected in recent years, about $12,000,000 in 1940 and probably much less in 1941. In fact, what is called capital-gains tax is really income tax on short-term risks. What are called short-term rates on capital gains are really income-tax rates.

II. RECOMMENDATIONS FOR LEGISLATION

(*d*) *Rates for public.*—May it be appropriate, therefore, to suggest as an experiment for 1 year, or during the war emergency, that the Senate adopt the revenue-producing provisions of a flat rate, eliminate the holding period, and allow deductions of capital losses only against capital gains and not against income. These provisions would apply, however, only to the general public.

(*e*) *Rates for professionals.*—As for the professional speculators, the Treasury thought that those who earn their living by speculation should not enjoy a preferential rate. Therefore, an exception should be made. Certain professionals should have less favorable treatment than the general public, such as floor traders who trade continuously and speculators on margin, who trade frequently on technical market factors rather than on major news economic and political, and who turn over their total invested assets or principal or cash equivalent more than, say, twice a year in peacetime or three times a year in wartime. For these, the compromise provisions mentioned above might apply, namely, a 6-month holding period, during which short-term capital gains would be subject to the high graduated income-tax rates, and thereafter to a flat capital-gains rate.

Inactive margin accounts might be pure investors who borrow money at low rates to buy bonds or shares yielding a high return. This is a legitimate business operation used in commercial banking and in carrying bond accounts.

It might be fair to give greater latitude to the small as against the large taxpayer. In peacetime the large investor might be allowed a single turn a year, in and out, i. e., buying and selling an amount equivalent to the value of the account at the beginning of the year. The medium-size investor would be allowed two turns. The small investor would be allowed three turns. During wartime, owing to the great uncertainty, one additional turn might be granted. To classify these three groups, the following rough definition might serve. A small investor might have interest and dividends up to $5,000, or market assets on January 1 up to $100,000. A medium investor might have interest and dividends up to $15,000, or market assets on January 1 up to $300,000, and a large investor sums exceeding the latter.

Another definition of a professional might depend on the percentage of capital gain to the total market value of securities, including the borrowed money. If capital gains realized within the 6-month holding period are less than at an annual rate of 15 percent the taxpayer would be classified as an investor. If more than 15 percent, he would be classified as professional. Such classification would depend on whether the taxpayer fell in either category, whether of trading turns or percent of capital gain, but not necessarily in both categories, thus widening the class of professional.

Finally, any person who trades on more than one kind of an exchange would be classified as a professional. For example, if he buys and sells stocks or bonds, and also wheat or cotton or sugar or coffee, he would be classified as a professional for tax purposes.

To reduce the burden on the Treasury in defining and classifying taxpayers as professionals, we might adopt the practical British procedure. Each stock-exchange city in the country and geographical areas outside of the 21 stock-exchange cities might have a local board of tax referees, consisting of one Treasury representative or other local Government official, one representative of the local or State bar association, the certified public accountants' society, the local stock exchange, and of the chamber of commerce or the public. These would be honorary posts. Appointments would be subject to the approval of the Treasury. Such decentralization would reduce the volume of litigation on capital gains, which is said to exceed that of any other tax.

Theoretically, the speculator should not be penalized. He makes money only if he buys at low prices or in a panic, and sells at high prices or in a boom. He thus performs a public service. Actually, this species has become almost extinct, owing to the restrictions of the capital-gains tax and of some of the too severe features of the otherwise good Securities Exchange Act of 1934. Today there are about six floor traders left on the New York Stock Exchange. The rest have either been forced out of business or gone to more profitable fields of activity. Most of the 323 specialists on the New York Stock Exchange have, by the operation of the above two factors, become less able to perform their necessary function. Many of the stock brokers are even unable to pay their annual dues to the exchanges. The New York Stock Exchange has publicly reported deficits in recent years. How long can this situation continue? Even the Securities and Exchange Commission is now worried and is making very earnest efforts to revive activity on the exchanges. These have a necessary function, as President Roosevelt himself pointed out several times, and most recently in a letter of May 15, 1942, to Mr. Emil Schram, president of the New York Stock Exchange, on the one hundred and fiftieth anniversary of the founding of the New York Stock Exchange—"* * * The continuation of an orderly market will be of vital importance both during the war and during the period of readjustment that will follow." Unless the capital-gains tax is made reasonable, practical, and revenue producing, the stock exchanges may be compelled to close. This would be a catastrophe for the whole system of private enterprise.

(*f*) *Rates for dealers and specialists.*—For dealers, like specialists who earn a livelihood by catching fluctuations, income-tax rates should apply without time limit. As before, specialists and other "dealers" would pay full income-tax rates on capital gains and would, of course, have the corresponding right to deduct capital losses from income, and have the right to carry losses forward like the merchant in any other field.

(*g*) *Comparisons with foreign countries.*—How severe these provisions for the general public are is indicated in the French experience. After the Nazi invasion a capital-gains tax of 33 percent was levied regardless of the length of the holding period. Within 9 months there were frequent and successive reductions of the holding period and of the rate. The final rate, effective in February 1942, was 10 percent on capital gains realized on securities held for 3 months. No tax was payable after 3 months. Under the above proposals the American public would be taxed after the 3 months, indeed, without any time limit. In other countries, like England and Canada, the public pays no tax on capital gains and deducts no capital losses.

(*h*) *Exempt farmers and home owners.*—In France no capital gains applied to farms or real estate, or stocks acquired through subscription right. We, also, should exempt from the capital-gains tax the home owner and the farmer who works his land for a livelihood.

A Treasury analysis for the year 1936 showed that of total capital gains, 85 percent were derived from securities and 15 percent from sale of other capital assets, including farms and real estate. To these the rise in value is incidental.

Consider, for example, the member of the Securities and Exchange Commission staff who bought a $5,000 home in Washington in 1941 and sold it for $7,000 in 1942, and for the proceeds bought a similar home in Philadelphia when the Securities and Exchange Commission moved there. Then, after the war, if the Securities and Exchange Commission returns to Washington and real estate falls,

he sells his Philadelphia home for $5,000 and for the proceeds buys a similar home in Washington, perhaps the very one he owned originally. He paid a tax on capital gains of $2,000 short-term or long-term, and is no better off than when he started. Where is the logic or justice of the tax on personal residences? Furthermore, capital loss on sale of a taxpayer's residence, not held as a business venture nor brought with intent to make a profit, is not deductible under section 23, and therefore should not be subject to tax on capital gain.

Again, if a farmer moves and buys another farm, he may get only the same kind of a farm as he sold. Why should he be taxed on a fictitious increase, due perhaps to lower purchasing power of the dollar, now increasingly threatened? If he has a capital loss, the carry-forward privilege even of 5 years is of little use. Farm land and homes are slow assets, not generally sold even once in 5 years.

(4) *Tax investors and dealers in farms and real estate.*—However, investors in income-producing farms or real estate, like investors in securities, should pay a capital-gains tax, without the limit of any holding period. Professional traders in real estate and holders of idle and unimproved land or real estate for a rise in value should pay income-tax rates on sales within 6 months and capital-gains tax rates thereafter. Among dealers in real estate and farm land there is no function corresponding to the specialist on the stock exchange, who may trade actively all day long. Real estate is a slow asset. However, brokers in real estate and farm land would, of course, be subject to full income-tax rates.

III. CONCLUSION

If statistics were kept separately for these categories, the Treasury would accumulate valuable data on productivity or yield for use in framing tax legislation in the future. Aside from the public, the professional traders and the dealers are insignificant in number, as well as in either potential revenue or the loss of revenue to the Treasury. The experiment would cost little, if anything, at the worst. It might also be productive of very great revenue—up to $600,000,000 per year.

Such a distinction would meet the objections of the Treasury about "favoring speculators." These would pay income-tax rates on capital gains within the trading turn. But the bona fide investor who switches occasionally from one security or other capital asset to another, including United States Government bonds would within this "holding period" pay only a flat tax on capital gains. The law would exempt entirely the bona fide home owner and the farmer who works his farm for a livelihood.

IV. APPENDIX AND TABLES

TABLE III.—*Total volume of trading on the New York Stock Exchange and the percentage of floor trading*

Year	Reported volume (million shares)	Floor trading (in percentages)		
		On floor	Off floor	Total
		Percent	*Percent*	*Percent*
1936	496	6.2	4.1	10.3
1937	409	5.9	3.9	9.8
1938	297	5.9	3.1	9.0
1939	262	5.9	3.0	8.5
1940	207	5.9	2.8	8.7
1941	171	4.1	2.7	6.8
1942	[1] 103	3.7	2.6	6.3

[1] Estimated.

Source: New York Stock Exchange.

Note the shrinkage in volume and the small and declining percentage of professional floor trading.

In 1941 there were 1,459,000,000 shares listed and the reported number of shares sold was 171,000,000, and the turn-over was 12 percent. Of the total sales the specialists did 7.3 percent of the business and the floor traders did 6.8 percent.

TABLE IV.—*Shrinkage in trading volume in relation to number of shares listed—Ratio in percent of number of shares sold annually to number of shares listed*

Year	Ratio	Year	Ratio	Year	Ratio
	Percent		*Percent*		*Percent*
1920	91	1931	44	1937	30
1925	99	1932	32	1938	21
1927	94	1933	50	1939	18
1928	132	1934	25	1940	14
1929	119	1935	29	1941	12
1930	67	1936	37	1942	[1] 7

[1] Estimated.

Note the shrinkage in the turn-over, i. e., the total number of shares sold to shares listed. The volume of trading in 1942 has declined to about one-thirteenth that of 1920 and to one-fourth that of 1932. The total volume of trading in 1939, only 262,000,000 shares, was less than in 1901, when the number of shares listed was only one twenty-third as great, less than in 1919, when the number of shares listed was only one-seventh as great, and less than in 1924, when the number of shares listed was one-third as great. The volume since 1939 has fallen further and is rapidly approaching a vanishing point. Note that the volume shrank with the rise in the rates of income tax applicable to short-term gains. The danger of closing the Exchange is a grave threat. Unless Congress does something soon there may be nothing left for the Securities and Exchange Commission to regulate.

Respectfully submitted.

ELISHA M. FRIEDMAN.

AUGUST 12, 1942 (as revised).

(On the taxation of capital gains, Mr. Friedman submitted the following brief:)

BRIEF OF ELISHA M. FRIEDMAN, OF NEW YORK, N. Y., ON THE TAXATION OF CAPITAL RISKS, SO-CALLED CAPITAL GAINS

"The capital gains tax, it could produce revenue and stimulate enterprise"

(Based on testimony submitted to the Senate Finance Committee on H. R. 9682, March 1938, and H. R. 5417, August 1941, to the House Ways and Means Committee, March 1942, and Communications to the New York Times, February 16, 1938, and August 10 and September 5, 1941)

I. INTRODUCTION AND SUMMARY

The term "capital gains tax" is a misnomer. It is a capital-risk tax. The present law on capital-risk taxation is futile and destructive. It does no one any good. It produces practically no revenue. It freezes the investor. It checks risk taking. It discourages enterprise. It creates unstable markets. A few changes would make it possible for the Treasury to get considerable revenue. The stockholder would also be able to turn around more easily. Markets would be improved and new issues facilitated. Subscriptions to defense bonds would be increased.

The present capital-risk tax is not a revenue producer. It is a revenue reducer. It is a fund-freezing order for American citizens. The rich do not take profits. They do not pay the tax. The tax was designed to "soak the rich." It soaks the little fellow.

II. WHAT ARE THE FACTS?

Private enterprise has been retreating for about a generation.—The long-term trend of railroad stock prices is downward since 1906. The index of utility shares is today below the low level of 1932. The reasons are well known. Industrial shares have been in a down trend since 1929. Except for the period from March 1935 to March 1937 there has not been any 2-year period from 1929 to 1941 which shows a sustained rise. There have been intermediate fluctuations, lasting several months. On these the Treasury collects little or no revenue.

The capital-gains tax would have been productive in an expanding private economy. It is futile in the present contracting private economy. The market value of all stocks listed in the New York Stock Exchange was at the high point

of the year; about 66 billion dollars in 1928, 90 billion dollars in 1929, 76 billion dollars in 1930, 60 billion dollars in 1936, 47 billion dollars in 1941, and 36 billion dollars January 31, 1942. Where are the long-term capital gains?

A group of million-dollar incomes published by the Joint Congressional Committee on Taxation, 1938, was traced for 20 years, 1917–36. If the 5 boom years, 1925–29, are eliminated, the remaining 15 years show a net capital loss. One group (No. 3) showed for the entire period 1917–36 capital gains of $63,000,000 and capital losses of $97,000,000, or a net loss of $34,000,000. The records of millionaire returns refute the basic assumption that capital gains represent ability to pay.

The figures for the country as a whole afford even more striking proof that capital gains do not represent ability to pay.

If the 5-year boom period 1925–29 is eliminated, the taxpayers of the United States had no capital gains but huge capital losses amounting to over $8,000,000,000 in the 19-year period 1917–24 and 1930 to 1940. (Source: Treasury Department, Division of Tax Research, February 9, 1942.)

III. EVILS

A. *The capital-risk tax does not reach the rich.*—In every Government report the facts are clear. Taxes on short-term capital gains were paid by the low-income-tax group, not by the high incomes. The richer the group, the less they paid on short-term capital gains in proportion to their total income.

B. *New ventures are checked.*—Senator Connally pointed out this evil. A report of the Senate Committee on Finance (1938) concedes this defect—

"The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises."

C. *The tax is inequitable.*—The Vinson report of the subcommittee of the committee on Ways and Means in the Seventy-fifth Congress, third session, on a Proposed Revision of the Revenue Laws, stated:

"Your subcommittee * * * recognizes the existence of a widespread feeling among taxpayers that it is inequitable and arbitrary to include capital net gains in the tax base for progressive income taxation while at the same time refusing to take account of capital net losses. * * * The existence of this feeling among the body of taxpayers, whether or not entirely justified, is prejudicial to the maintenance of proper relations and necessary cooperation between the Government and its citizens in the administration of the revenue laws."

D. *Foreign experience is significant.*—Mr. André Istel, citizen of the French Republic, formerly private banker in Paris and technical adviser to the French Ministry of Finance, also a member of the faculty of the École Libre des Hautes Études, a French and Belgian university in New York stated to the House committee in March 1942:

"France never had a capital gains tax until after the Nazi invasion. The original terms were 33 percent regardless of length of time of holding of securities. In February 1942 the law was relaxed in order to accomplish its original purpose. The rate was reduced to 10 percent. The time limit was reduced to 3 months. No tax was payable on gains realized after the 3-month holding period. Capital gains of less than 5 percent were free of tax. No tax is levied on stocks acquired through subscription, nor on stocks acquired by inheritance. Most important of all, at no time were capital gains on securities ever considered as income. Therefore, they were never subject to the graduated income tax.

"As the matter now stands, the French tax on capital gains on securities has in fact lost practically all significance. At no time since the law was first enacted in France, did the capital gains tax apply to farm land, to real estate, urban or rural, or to any other capital asset. * * * I consider that the established principles of taxation are to disturb the economic life as little as possible, and I consider the proposal of a heavy capital-gains tax would have a detrimental effect on the economic situation, because it would have the effect of increasing the economic swings both ways."

Mr. Albert Andriesse, a retired banker, citizen of the Netherlands and a former partner of the banking house of Pierson & Co., Amsterdam, Holland, stated:

"In May 1941, under German occupation, a capital-gains tax was introduced, but up to May 10, 1940, the date of the invasion, there never was such a tax in the Netherlands on individual investors.

"According to the system of taxation in my country, capital gains are not considered as part of income. In defining income the Dutch legislator follows the principle of taxing only the yields of the various sources of income, namely, of

capital, labor, securities, real estate, and land. But the incidental gains that result from a change of ownership of the sources themselves, are not considered as income, nor are such incidental losses deductible from taxible income.

"Apart from the theoretical considerations there are, no doubt, important practical motives which kept the Netherlands Government from including capital gains in taxable income.

"As is well known to you, most public utilities in Holland, including railroads, telephones, telegraph, gas and electric services are owned and operated by the state, the Provinces, or the cities, thus tending to show that the Government does not hesitate to intervene in the economic life of the country whenever it believes it to be necessary.

"But the Dutch Government is a convinced adherent to the capitalistic system of production, in which individual risk and private initiative play a leading part. The Dutch Government has therefore always tried to hamper as little as possible the free play of that fructifying process in every field not reserved for Government operation. That liberal policy also involves a constructive and friendly attitude of the Government toward public markets.

"In modern times the significance of stock markets has greatly increased. The amounts of capital required for the development of new industries and steamship lines in Holland, and for the opening of mines, oil fields, and plantations in the Dutch colonies have risen far beyond any individual's financial capacity and willingness to take the risks involved. In many cases it takes several years before the capital invested can be expected to show a return. Five to six years are required to bring to fruition a palm-oil plantation. Rubber plantations take even longer. Tying up capital without yield for such long period entails a strong element of speculation. Consequently, the necessary means can be obtained from the capitalist only by the hope of commensurate return from the capital invested and by the hope of capital gains.

"In view of the diversified system of rather heavy taxation it is evident that it is not by oversight or neglect that the Dutch Government, although it has often been in dire need of additional revenue, has never enacted a capital-gains tax.

"Obviously, it is known that such a tax has the tendency of killing the goose that lays the golden eggs. What golden eggs? The regular employment of tens of thousands of people, at work in the new enterprises, meaning so many more taxpayers, and fewer recipients of the dole. Besides, more taxes are reaped from the new corporations. Further, it was no doubt realized by our authorities that the introduction, even of a moderate capital-gains tax, not only would have a harmful effect on new enterprise, but that it also would spoil the free functioning of security markets, which they believe to be in the paramount interests of the country, as long as it works under the system of private enterprise and individual initiative."

Mr. D. M. Van Buuren, citizen of Belgium, formerly professor of the Ethics of Finance at the University of Brussels and a private banker, stated:

"The following information concerning Belgian taxes refers primarily to the situation before the invasion in 1940. There was no tax on capital gains in Belgium for individuals. The State took the position that fluctuations in prices of securities or of real estate or of other capital assets were too uncertain to be made a source of Government revenue."

IV. CAUSES, PARADOXES, AND ERRORS

A. *Capital gain is not income.*—No competent accountant could define income so as to include capital gains. Capital gain is not income. Capital gain may turn to capital loss. But income cannot go below zero, unless the office boy pays the boss. Income persists. Capital gains do not. When individuals' incomes rise, the national income rises. But when individuals have capital gains, realized or unrealized, the national income is unaffected.

B. *Capital gains arise from inflation.*—Capital gains may indicate not an increase in real value, but only a change in monetary value. Capital gains may arise from change in the value of the dollar, and in other factors which have no bearing on real value.

C. *The tax on capital gains is contingent, not absolute.*—This is the unique and distinguishing characteristic of the capital-gains tax. It is stated effectively in the report of the Senate Committee on Finance:

"There is no tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer

his investment from a bond in one company to a bond in another company * * * (Senate Finance Committee report, 1938, p. 9).

or if he exchanges two similar stocks like Westinghouse and General Electric or if he exchanges any security into a United States Defense bond. In capital gains, the taxpayer decides whether or not to realize the gain. That decision is affected by the rate. The Treasury is not the boss. The taxpayer is.

D. *Holding period is an artificial distinction between speculation versus investment.*—There is nothing in accounting, in economics, or in fiscal policy which justifies the distinction of speculation and investment on the basis of time. There is no justification for segregating short-term from long-term gains and losses. They arise from the same motive. They are realized in the same way. Common stocks, most preferred stocks, and many bonds are speculations. The risk is inherent. Time does not lessen risk. It increases risk. The buyer can attempt to look 2 months ahead. Who can foresee 2 years ahead?

E. *The law must defeat itself.*—If the taxpayer sells his securities, he will not repurchase because the new holding would be subject to income-tax rates up to 82 percent during the 15-month holding period. Who would take risks with the odds thus stacked against him? Again, if the taxpayer sells and realizes a gain, he can and will offset this gain by selling securities which show a paper loss. The market therefore is limited to the smallest holders in the low income-tax brackets, and who can furnish but little tax revenue to the Treasury. In addition, the small stockholders are neither wise nor courageous risk takers. They follow, but they never lead.

Again, the capital-gains provisions are affected even though the rates are not changed. When the income-tax rates are sharply graduated, short-term capital gains rates thus automatically and correspondingly increase. It is for this reason that the Treasury receipts showed sharply declining revenue from capital gains from 1938 to 1940, even if capital gains tax rates stayed constant.

F. *Court decisions cast doubt on legality of tax on capital gains.*—Godfrey N. Nelson, a noted tax authority, in an address at the Duke University Law School, cited the following supporting opinions and decisions:

"The earliest income taxes enacted in the United States on which court decisions are available were those of 1864 and 1867. In part the 1867 statute read as follows:

" 'There shall be levied, collected, and paid annually upon the gains, profits, and income of every person, * * * whether derived from *any kind of property*, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, * * * *or from any other source whatever*, * * * a tax of 5 percent on the amount so derived over $1,000.' [Italics supplied.]

"This statute was before the United States Supreme Court in 1872 on the question as to whether an increment in value of personal property, occurring during a period of years, constitutes gains, profit, or income of any particular year. (*Gray* v. *Darlington* (15 Wallace 63)). The Court held that such increment was not income even though he entire amount of increase in value be at any time converted into money by a sale of the property. The majority opinion (from which there were three dissents) reads as follows:

" 'The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. *It constitutes and can be treated* merely as increases of capital.' (Italics supplied.)

"The 1909 Federal income tax also presented questions as to the taxability of capital gains. The Commissioner of Internal Revenue ruled under the excise tax that capital gains were taxable as income. In a suit to recover a tax paid under protest upon such gains a United States District Court, in 1915, gave judgment for the corporation (*Mitchel Bros. Co.* v. *Doyle* (225 Fed. 437 (W. D. Mich. 1915)) holding that capital gains are not taxable. Upon appeal by the Government the district court's findings were sustained by the circuit court of appeals in 1916 (*Doyle* v. *Mitchell Bros. Co.* (235 Fed. 686 (C. C. A. 6th, 1916)).

"Again, the Government appealed, and in May 1918, during the World War I, when the income tax had been in effect for 5 years under the sixteenth amendment, the Supreme Court reversed the lower courts, holding the capital gain to be taxable. In the war emergency the need of large revenues was being experienced; high rates were being imposed and higher rates were in prospect.

"Because of pressure for revenue the court obviously refused to give consideration to any meaning of the word 'income' other than that previously adopted in respect to capital gains under the corporation excise tax law of 1909.

"The taxation of capital gains has been given more special legislative treatment, and litigation thereon has been of greater volume, than any other branch of income-tax law. The numerous and ever-growing exceptions to the taxability of capital gains, moreover, indicate its eventual elimination. Being wrong in principle, the taxation of capital gains should be repealed at the close of the present emergency."

V. RECOMMENDATIONS FOR LEGISLATION

The defects of the present capital-gains tax have been exposed. The cost in revenue to the Treasury has been shown. Certain obvious recommendations for legislation follow. They were embodied in the Boland bill, H. R. 6258, which is respectfully urged for adoption by your committee.

A. *Segregate capital gains and losses from regular income.*—The House committee actually considered "the complete segregation as a tax base of capital gains from other sources of income." (Vinson report, 1938, p. 32.)

B. *Restrict offsets of losses to segregated gain.*—Under the principle of segregation, capital losses would never be applied against regular recurring income. The whole tax procedure would be simplified.

C. *Set a rate to produce maximum revenue.*—Certainly a low flat tax on capital gains, regardless of the holding period or the time of realization, would produce revenue.

D. *Eliminate the holding period.*—The holding period is arbitrary, as congressional reports admit.

E. *Carry losses forward during one whole business cycle.*—The business cycle runs generally about 33 months. It should be satisfactory to have a carry-forward privilege of 2 years or at most of 3 years.

F. *The recommendations are supported by bankers, by real-estate interests, by farmers' representatives, and by labor.*—A supporting resolution was adopted by the Georgia Bankers' Association fifty-first annual convention, 1942, at Atlanta, Ga.:

"Whereas the present capital gains and loss provisions of the Internal Revenue Act are detrimental to capital and the investment thereof; and

"Whereas H. R. 6358, a bill to correct these evils, has been introduced in the House: Now therefore be it

"*Resolved*, That the Georgia Bankers' Association recommends the passage of this bill as presented."

A supporting telegram of real-estate interests was sent to Hon. Robert L. Doughton, chairman of the House Ways and Means Committee, on March 19, 1942:

Real estate men generally approve Boland bill

1. Because we believe more revenue will be obtained by Government through this amendment.

2. More real-estate activity will result and less frozen situations.

3. Capital gains are from long view fictitious, as history of real estate shows that losses eventually equal or exceed gains.

CLARKE G. DAILEY,
President, Alliance Realty Co., New York, and Officer in Several Other Real Estate Companies and Associations.

The following resolution was passed unanimously by the National Association of Commissioners, Secretaries and Directors of Agriculture at a meeting in Washington, D. C., March 31, 1942:

"Whereas it has been proved the capital-gains tax destroys incentive for capital investment and thus handicaps business and production and results in less tax returns to the Treasury;

"Whereas this has been harmful to industry, labor, and agriculture: Therefore be it

"*Resolved*, That the National Association of Commissioners, Secretaries, and Directors of Agriculture, meeting in Washington on the 31st day of March 1942, urge the Congress to repeal the capital-gains tax, and that the secretary be instructed to send a copy of this resolution to all Members of the Congress, both Houses."

The report, dated March 20, 1942, of the tax committee of the executive council of the American Federation of Labor, consisting of Secretary-Treasurer George Meany, Vice President Matthew Woll, and Vice President G. M. Bugniazet, reads in part:

"One tax which has an important effect in slowing up investment in new venture enterprises, is the present capital-gains tax. If this is not repealed by the new 1942 Revenue Act, it should be sharply modified to tax capital gains at lower rates, and to liberalize the provision for the deduction of capital losses. Failure to take such action in earlier laws has led to a sharp reduction in capital available for new venture enterprises, because of the heavy taxes involved if the business venture is successful, and because of the denial of reasonable credit against other profits if the new venture is not successful."

VI. BENEFITS

The Treasury would get increased revenue. The defense program would be aided. Government bond subscriptions would be increased. The whole system of private enterprise would receive a new stimulus.

A. *Revenue from capital gains would increase.*—The Treasury could make a simple calculation to estimate the increase of revenue. Without any time limit or holding period for capital gains the Treasury would receive probably between $200,000,000 and $600,000,000 in tax receipts on capital gains on New York Stock Exchange securities traded within the year. The actual amount would depend on the fluctuations and the activity. To this would be added tax receipts on securities held for longer periods. In addition to the $54,000,000,000 of stocks listed on the New York Stock Exchange there are $184,000,000,000 of other assets on which there may be capital gains subject to tax.

At the end of 1940 the total value of all farm land and buildings was $34,000,000,000, and the total cost minus depreciation of all nonfarm dwellings in the United States was $80,000,000,000. On this combined total of farm and nonfarm land and dwellings, $114,000,000,000, capital gains would be taken and taxes paid to the Treasury.

B. *Other phases of national economy would benefit.*—Capital now frozen would become mobile. New enterprises, particularly small business, would revive. New sources of income-tax revenue would be opened up Not least, the receipts of the Federal and State Governments from stock-transfer tax would double, and this would amount to about $18,000,000 for the Federal transfer tax and about $21,000,000 for New York State transfer tax.

C. *The defense program strengthened.*—Capital now locked up could go into the development of mining defense minerals, now languishing for lack of risk capital.

D. *Real estate and home building would be stimulated.*—The modification of the capital-gains tax in the direction indicated would have many beneficial results in real estate. Obviously transactions would be increased so that there would be a better market both for buyer and seller. What is more important, however, is that much real estate is now in financially weak hands who are unable to improve it. A less restricted market, such as would result from a modification of the capital-gains tax would enable such real estate to get into financially stronger hands who would improve the property, raise the standard of dwelling, and furnish more and better housing in existing buildings.

Furthermore, it would stimulate new building. A great program of slum clearance by private enterprise has been proposed. A shortage of residential dwellings must result from wartime priorities. The building and real-estate section of our economy could furnish an important stimulus to the post-war transition, and the shackles of the present capital-gains restrictions should be removed from it.

E. *The post-war readjustment would be aided.*—The end of the war will usher in a host of problems. It will involve change of values. Private enterprise will have to take over the burden of liquidating the war.

The Reconstruction Finance Corporation portfolio has risen greatly as a result of armament, defense, and war. After the war it will be desirable that this portfolio be liquidated; that it be transferred from public to private hands. Indeed, the risk to the Government is very great in holding such large blocks. To transfer this risk to private enterprise will require better markets, facility in buying and selling, and encouragement to the private risk taker. Modification of the capital-gains tax could accomplish these purposes.

Again, our plant capacity has been greatly increased. After the war it will be necessary that many of these plants be sold and adapted for new purposes. This will require freedom in buying and selling and a good market. The process of post-war adjustment will be facilitated by the proposed amendment of the capital-gains tax.

Furthermore, there will be great need for international reconstruction by the United States. This will require a sound and workable financial machinery, freed of futile or harmful features. Furthermore, the financial center of the world is passing to the United States. Whether it will succeed in staying here depends upon broad vision and statesmanlike attitude toward the investor and the stockholder, who will be asked to furnish the funds for such reconstruction.

If private enterprise is to assume any share of these burdens, it will have to be unshackled from restrictions now inherent in the capital-gains tax. An intelligent revision of the capital-gains tax will enable private enterprise to resume its historic function to the benefit of the community.

VII. ANALYSIS OF CRITICISM OF PROPOSED PROVISIONS CONCERNING LOW RATES AND ELIMINATION OF THE HOLDING PERIOD

A. It is argued "The Boland bill would abandon the principle of ability to pay with respect to capital gains of individuals." But capital gain does not measure ability to pay. It is an illusion to think so. This illusion is refuted by all the available official statistics on capital gains.

The best refutation of this illusion is a report of the Joint Committee on Internal Taxation entitled "Million Dollar Incomes" (1938). Group 2 consists of taxpayers who derived more than 50 percent of their income from net capital gains in the years 1926 to 1929. For the period 1917 to 1936 the capital of this group decreased from $146,000,000 to $117,000,000 (p. 13). There was a capital loss of $23,000,000 for 20 years. Group 3 showed for the entire 20-year period capital gains of $63,000,000, capital losses of $97,000,000, and net capital losses of $34,000,000. This congressional report confirms the conclusion from the Treasury reports. Capital gains do not persist. They are not recurrent. They do not represent capacity to pay. Neither in the scientific laboratory nor in the field would such striking evidence be ignored. Shall we act like Bourbons, learning nothing, forgetting nothing? Why does H. R. 7378 provide legislation on an assumption that not only has never been supported by statistics but strikingly contradicted? Why does the House bill legislate this theory when the facts cited above are available in Government documents universally accessible and have been presented at previous hearings on the capital-gains tax? As Samuel Johnson said, "Experience becomes the great test of truth and is perpetually contradicting the theories of men." Experience dissipates error.

B. *Another criticism is "The Boland bill would eliminate the very real and equitable distinction between short-term and long-term capital gains."*—Is there any such real and equitable distinction? What is the history of the holding period? From 1913 to 1921 there was no distinction. From 1921 to 1933 a 2-year limit separated short-term from long-term gains. From 1934 to 1937 there were five holding periods: Under 1 year, 1 to 2 years, 2 to 5 years, 5 to 10 years, and over 10 years. The law arbitrarily stated that capital gains or losses in these five periods would be considered as income up to the following percentages, respectively: 100 percent, 80 percent, 60 percent, 40 percent, and 30 percent.

In 1938 the Vinson subcommittee on taxation of the House Ways and Means Committee admitted that the above 5 holding periods were arbitrary and therefore recommended that the holding period be increased to 49 periods, making a gradual step-down in rates, changing 2 percent each month from the thirteenth to the fortieth month, and 1 percent each month from the forty-first to the sixtieth month. This proved impractical. The error of making a distinction between short-term and long-term gains led to a subsequent error of proposing 49 classifications. Instead the act of 1938 reduced the number of holding periods from 5, in effect since 1934, to 3, namely, under 18 months, 18 to 24 months, and over 24 months. These are now in effect. Apparently no one, thus far, knows what is the difference between long-term and short-term gains.

The House bill H. R. 7378 recommended virtually that the difference between long-term and short-term gains be eliminated. Specifically it provides that long-term losses should be deductible from short-term gains and that short-term losses from long-term gains, and also that long-term losses and short-term losses should be treated alike; neither should be deductible from ordinary

income. Apparently it intended to wipe out the difference. But critics object to the Boland bill because "it would eliminate the very real and equitable distinction between long-term and short-term capital gains." However, did not the House bill do so? Does not this criticism seem inconsistent?

In fact, there is no difference between long-term and short-term gains. Under the House bill brackets, taxpayers might pay 82 percent on short-term gains taken in 14 months and 29 days, and then pay 30 percent on long-term gains taken only 2 days later, in 15 months and 1 day. What logic would justify such a proposal? Why not return to reason and experience? Abandon the illusion that there is any difference between long-term and short-term gains.

C. *It is said further "The Boland bill would place a premium on speculation as a way of securing a living."*—A speculator makes money only if he sells securities when they are high and buys them when they are low. Unfortunately, almost everybody does the reverse—buys at high prices and sells at low prices. The theoretically ideal speculator really performs a public service. Unfortunately there are all too few of him. Speculation as a way of life is notoriously rare. Where are the great speculators of the 1920's—Cutten, Durant, Livermore, Danforth, etc.? They are either impoverished or they committed suicide. In our contracting economy, with its consequent long-term bear market, speculation has become more difficult than ever. Yet it is in long-term periods of pessimism and of periodic psychological hysteria that the ideal speculator would be a public benefit. He prevents losses to the public which buys shares at the peak and which sells shares at the bottom. The law should encourage, instead of punish, such stabilization operations. On every major crisis, the New York stock market fell more sharply than the markets of Europe, notably in April 1939 and May 1940. The chief reason is probably the restrictive effect of the capital-gains tax, absent in the freer markets of Europe.

D. *Another argument is "The Boland bill would favor a relatively small group of high-income bracket taxpayers."*—Why would it favor this group? Every Treasury table published for over 20 years shows that taxpayers in the high brackets take little or no short-term capital gains. The Treasury receives little or nothing. In fact, the Treasury report, Statistics of Income for 1938, shows a tax vacuum of over $250,000,000 in the upper income brackets on short-term gains, taxed at high graduated rates against long-term gains taxed at lower rates. A low rate will produce revenue. A 10-percent rate favors not "a relatively small group of high-income bracket taxpayers." If getting people to pay a tax is "favoring" them, let's do a lot of "favoring." The Government needs revenue. In the 1938 Senate hearings on H. R. 9682, Senator Connally stated to Under Secretary Roswell Magill (p. 500): "I am coming around to the view that as to capital gains and losses we should make it more attractive to a man to sell instead of offering him a premium to hold."

Is it socially useful or economically desirable that those best able to undertake the risks of stabilizing markets should be prohibited from doing so—or that those least able to do so should be encouraged to do so? Is it logical to impose a capital-gains tax and then set rates so high as to prevent the Government from obtaining revenues therefrom?

To raise the income-surtax rates to 82 percent and then to create the artificial classification of short-term gains, so as to furnish an excuse to tax them at that rate, is a sure way not of producing revenue but of preventing revenue, not of punishing a small group of high-income bracket taxpayers, but of punishing the Treasury and punishing the other taxpayers who must take over the burden of such fiscal errors.

E. *The critics say "The Boland bill would open the road for tax avoidance" by lowering rates of tax on capital gains.*—But every table and chart based on Treasury figures prove the opposite. High capital gains taxes check selling. In the hearings before the Senate on H. R. 9682 (p. 702) Senator Connally stated in essence, "There is a difference between ordinary income and capital gains. The taxpayer must pay on ordinary income. He has no choice. But on capital gains he has a choice. He does not have to realize on his gains. Unless he does, we shall not get revenue." This is the kind of tax avoidance that the House bill does not try to check. The Senate Finance Committee report, 1938 (p. 6), likewise stated substantially, "There is an essential difference between income and capital gains. If income is earned, the tax must be paid. But on capital gains the tax is optional. The taxpayer need not pay any tax unless he sells." The Treasury receives no revenues. Taxes are avoided.

The report of the House Committee on Ways and Means, 1938 (p. 7), likewise pointed out the difference between ordinary income and capital gains. It

showed that "No matter how high the rates, the taxpayer benefits from an increase in income. But on capital gains the appreciation does not have to be taken. It is optional with the taxpayer. He can avoid the tax by refraining from selling." The House bill does not face this kind of tax avoidance.

F. *Again it is argued: "The Boland bill would provide an excessively low rate of taxation."*—Is the 10-percent rate of the Boland bill excessively low? Assume a stock earns $6 and sells for $100. Assume that the earnings increase $3 to $9 and the stock rises to $150. If the stockholder sells, he takes a $50 capital gain. On a 10-percent tax, he pays $5 or 160 percent of the $3 increase in earnings. Is that tax low? Or is it confiscatory?

Or let us regard the capital-gains tax as a sort of transfer tax. A 10-percent rate on capital gains for the privilege of transferring from one security to another is a terrifically high rate when compared to the transfer tax now in effect. This amounts to 0.25 percent to 0.33 percent of the market price. The transfer tax yielded $12,000,000 in revenue to the Treasury. In 1940 the capital-gains tax, including an 80-percent tax on short-term gains, brought likewise only $12,000,000. If short-term losses were allowed in full, the $12,000,000 would probably be zero or a minus quantity. Treasury statistics show capital-gains tax averaged $31,200,000 in the decade 1931–40. The yield would have been even less had not the Government limited deduction of capital losses. The stock-transfer tax averaged annually about $23,200,000 for the same decade. But it never showed a loss to the Treasury. It never befuddled markets. It was simple to administer and to collect.

Critics of the Boland bill attempted to prove that high rates on capital-gains tax are productive. They said that in the years 1926 to 1933 the net revenue from capital-gains tax amounted to an average of $169,000,000, and for the years 1934 to 1937 the revenue averaged $91,000,000. It is interesting that this decline in revenue occurred under higher rates of tax on capital gains.

For the 10-year period, 1931 to 1940, the capital-gains tax produced an average of $30,000,000 a year. The recent yields have been particularly unproductive, about $27,000,000 in 1939 and $12,000,000 in 1940. To quote Horace, "The mountains were in labor and brought forth a mouse." But in 1931, 1932, and 1933 the Government lost $184,000,000 in revenue through deduction of capital losses from the income tax. But in the same 3 years the stock-transfer tax provided $76,000,000 of tax revenue to the Government. What more striking evidence that capital-gains tax is unproductive as well as complicated and pernicious, compared to the stock-transfer tax?

Critics try to prove that low rates have little effect on the amount of revenue. However, the report to the House committee, entitled "Million Dollar Incomes" (1938), does not support this conclusion. In the depression, 1930 to 1932, under low taxes, capital gains was a higher percentage of total income than during the recovery period, 1932 to 1936, under high taxes. Conversely, losses deducted were lower in the depression from 1930 to 1932 under low taxes than in the recovery, 1933 to 1936, under high taxes.

The conclusion is obvious. An analysis of the proposals for high tax rates on capital gains shows that it ignores official statistics. Figures are not adduced to support this position. There are no such figures available in any Treasury document. This stand is based on an illusion, an illusion as seemingly real yet actually deceptive as the theory that the sun from morning to evening revolves around the earth.

A book, War, Politics, and Emotion, by a physician, Geoffrey Bourne, published last year by Liveright in New York, would be very helpful for the understanding of many of our present-day problems. He says, "The great handicap to the solution of social and political questions is that we rush to apply emotion as cures without first attempting to understand the rational cause. No medical man would attempt to treat any disease in this spirit."

Twenty-five years of experience with the capital gains illusion shows that it produces little or no revenue; that it prevents shifts from one security to another, even into United States Defense bonds. Under this illusion the Treasury has seen potential taxes come and disappear, like a farmer watching a crop grow and rot. This illusion has created unstable and hysterical markets. This illusion locked up American stockholders in 1928 and in the spring of 1929, when all European markets, free of capital-gains illusions, were turning down, and when Europeans were selling American shares in the London, Amsterdam, Paris markets free of capital-gains taxes. This illusion is one of the most vicious fiscal concepts that ever afflicted a nation. It brought no benefits. It wrought much evil.

Troubled times face us after the war. American economic life must be rid of this illusion if the country is to face its problems realistically. Unless adequate supporting data can be adduced, this illusion should be extirpated from American fiscal thinking. The capital gains tax has no place in our fiscal system.

But the Government needs revenue in wartime. The Boland bill will save the revenue-producing possibilities of the capital gains tax. It should be enacted into law for the duration of the war unless better support in facts and figures in favor of high rates and in opposition to low rates than has been the case thus far.

G. *It has been argued that "The direct yield from capital gains and losses will be less under H. R. 6358 than under the House bill H. R. 7378."*—I have proven conclusively from the Treasury's figures for the years 1938, 1934, and for the period 1926 to 1933 that (1) high rates produce little revenue; (2) low rates produce much revenue. The rates in H. R. 6358 are 10 percent. The rates in the House bill H. R. 7378 are 25 percent. Can anyone find any official figures for any year to disprove the above conclusions?

Representative Reed asked Mr. Paul in the hearings of March 30 how much revenue would be lost if H. R. 6358 (the Boland bill) is enacted. Mr. Paul promised the figures. They should be helpful and illuminating. They have not been furnished after a lapse of 4 months. Representative Carlson then asked: "What would be the loss or gain in revenue if the Treasury's proposal were adopted?" Mr. Paul did not answer the question, and promised no computation or estimate. He merely stated that he expected that there would be a gain. These figures have not been furnished to date, August 7, 1942.

H. *Direct yield from capital gains.*—The rates were lowered for the year 1938 and Mr. Paul admitted: "The estimated total net capital gains * * * rose from $661,000,000 in 1937 to $817,000,000 in 1938." Mind you, 1937 marked the end of a long bull market which started in 1933. Not also that 1938 marked the bottom of the sensational bear market (April 1) and the average stock price level in 1938 was about equivalent to that of 1935. Yet the lower rates produced more capital gains in the poor year 1938 than did high rates in the good year 1937.

Representative Carlson in the hearings of March 30 asked Mr. Paul if capital losses did not wipe out capital gains over an extended period of time. Mr. Paul replied that there was a substantial net gain for the whole period. But the Treasury figures released on March 18 and cited in my testimony on March 20 show that if the 5 extraordinary years 1925–29 are omitted there is a net capital loss of over $8.3 billion, or an average net capital loss per annum of $447,000,000 for all the remaining 19 years, 1917–24 and 1930–40 (page 931).

Representative Carlson inquired whether capital losses or deductions from income were taken into consideration. The Treasury's figures show the amazing fact on exhibit 7 that the years 1938, 1939, and 1940 each had a net balance of long-term losses, but exhibit 8 for the same 3 years shows net revenues from capital gains. How can the Treasury get net revenues out of taxpayers' net losses?

Mr. Paul stated further: "The proponent of H. R. 6538 (the Boland bill now suggested to the Senate Finance Committee) who presented the most detailed statistical evidence, Mr. Elisha M. Friedman, estimated that * * * the bill would bring a permanent annual yield of between $200,000,000 and $600,000,000, as compared with an average yield of $30,000,000 a year during the decade 1931–40. * * * Mr. Friedman's estimate that the 10-percent flat rate * * * would yield between $200,000,000 and $600,000,000 a year would require between $2,000,000,000 and $6,000,000,000 of net capital gains * * *. In 1938 * * * only about $657,000,000 of net long-term gains were reported." Mr. Paul has thus presented the figures which support and confirm my estimates. In moving from the bottom of the year to the top of the year the market does not move in a straight line. It travels over a long round-about range or "mileage." Over a period of years this mileage is from 2 to 5 times the net advance. In 1938 this ratio happened to be 3.2 times. Now under the Boland bill urged for adoption there is no difference between long and short gains. Therefore, the Treasury would have collected taxes on all the intermediate movements, amounting to capital gains of 3.2 times the above $657,000,000, or $2.1 million. On this sum a 10-percent rate of tax would thus furnish more than the minimum estimated yield of $200,000,000 in a year like 1938, which included the vicious end of a bear market that, in all, cut the Dow-Jones average of industrial stock prices by 50 percent.

Furthermore, the Boland bill would make it possible to include short-term gains from the brackets, not only of the low incomes but also the high incomes, who now cannot realize them. Mr. Paul stated that the short-term gains in

1938 were $160,000,000. However, in the low-income brackets where short-term gains and long-term gains were taxed at the same flat rate in 1938, the short-term gains were actually greater than the long-term gains. For example, on incomes under $5,000 short-term gains were 150 percent of long-term gains. Of course, as the income-tax rates rose, this percentage of short-term gains faded away from 150 percent in the lowest income bracket to 0.30 percent in the highest income bracket. If the rates of tax on capital gains were low and flat, then all income brackets should show short-term gains equivalent to 150 percent of long-term gains. Mr. Paul stated that long-term gains in 1938 were $657,000,000. Therefore, on the above calculation, short-term gains should be 150 percent, or $985,000,000. On this amount a 10-percent rate would, therefore, add approximately another $100,000,000. On Mr. Paul's own figures, therefore, the Boland bill would have shown for 1938 a net yield to the Treasury of more than $300,000,000.

Mr. Paul calls these estimates "extravagant." They were indeed "extravagant" in comparison to the $12,000,000 apparently collected in 1940. But any reasonable calculation on the basis of the value of all shares listed on the New York Stock Exchange would support the estimate of a minimum yield of $200,000,000 from the New York Stock Exchange alone. In addition to the approximate $40,000,000,000 of market value of stocks listed on the stock exchange, there were in 1940 farm land and buildings of $34,000,000,000, and non-farm dwellings of $80,000,000,000, or a total of $114,000,000,000. There are also about $70,000,000,000 of stocks unlisted and dealt in on other stock exchanges, making a grand total of about $180,000,000,000. A realistically framed capital-gains tax law should make these assets of farmers and real-estate owners become liquid and should increase the above estimates based on New York Stock Exchange transactions alone. The estimate of a maximum yield of $600,000,000 is based on active years when the stock-exchange fluctuations were greater than in 1938 and when the travel ratio or mileage was greater. Details are shown in my statement before the Senate Finance Committee on H. R. 5418, August 13, 1941.

I. *Indirect effects of capital gains and loss taxation on revenue from other sources.*—Officials stated: "The imposition of a low tax rate on capital gains * * * would give * * * a strong incentive to convert other income into capital gains. * * * A stock may be purchased ex-dividend, i. e., immediately after the payment of the dividend, and sold cum-dividend at a gain, immediately prior to the payment of the next dividend. The dividend, which accounts for part of the difference in price, is in effect realized as a capital gain." Let us assume a stock pays $1 quarterly. Who would be so unwise as to buy a stock paying a dollar quarterly for the purpose of getting a $1 rise or capital gain in the price in 3 months to avoid paying income tax on the next dividend? What a risk to take for 3 months. Such a buyer might find that the price of the stock went down 20 points in the 3 months between dividends. This argument seems to reveal unfamiliarity with the securities markets.

J. *The effect on the volume of market activity.*—To say, as do officials, that the volume of activity from year to year depends on other factors besides the capital gains tax is a truism. To compare yields of capital gains tax in various years is gratuitous. The important fact is that in any one year and in every year the volume of capital gains realized moves in very close correspondence with the varying rate of tax on the several income brackets. The correlation is astounding as shown in table IV, page 10, Statistics of Income for 1938. Let the tax experts pick a single year in which this is not true. In any year all other conditions remain the same for all tax brackets and the sole variant is the graduation in tax rates on the several brackets of income within the year. To compare several years or to introduce aliens factors is to confuse the issue. One fact stands stark and bold. Rates of tax determine the volume of capital gains for every income bracket within every year from 1917 to 1940. Low rates produce large gains. High rates produce low gains.

K. *Effects on risk capital.*—Officials stated: "The Treasury proposal (since embodied in the House bill H. R. 7378) * * * grants special relief to persons deriving incomes from capital gains, providing a lower maximum rate on long-term capital gains than on other income." Here again is a confusion of thought between capital gains and income. Capital gains are not income. Until this is admitted there can be no meeting of minds. If one argues that 2+2 equals 5, then, of course 4+4 might equal 10. One can thus develop a whole series of corollaries, all consistent with each other, but all of them utterly false. Treasury testimony on March 12 shows that though income persists and is

fairly regular, capital gains fluctuate wildly and turn to losses. Wage or salary never becomes a minus. There is no point of similarity between capital gains and income except that they are both expressed in dollars and a taxpayer receives them. They are as similar as pigs and pig iron. A tax on capital gains is a tax on capital.

L. *Consideration of equity, or the taxation of gains at progressive rates.*—The Treasury states that "to tax capital gains at a flat 10 percent at the time that income would be taxed up to 90 percent is indefensible discrimination." There was no discrimination from 1918 to 1921. Capital gains were considered as income. Capital losses were considered as deductions from income without limit. As a result of such deductions the Treasury lost much tax revenue during these years. After 1922 a discrimination was made. The laws on capital gains taxes and income taxes were amended and modified independently of each other, as shown in the Vinson report (1938) which gives the history of legislation on capital gains. A striking recent case is the fact that in 1938 the income-tax rates remained unchanged under the 1936 law but the capital-gains-tax rates were drastically reduced. For example, for a taxpayer in the $500,000 bracket of income, holding securities for more than 2 years, the rate on capital gains was cut from 42 percent in 1937 to 15 percent in 1938 though his income-tax rate remained unchanged. But capital gains is not income. Why confuse the two? Does the individual in the high-income bracket pay a higher rate on the stock transfer tax than one in the lower income brackets? Does the person in the high-income bracket pay a higher rate of excise tax on beer or on chewing gum than one in the lower income brackets? What does an 88-percent income tax have to do with the rate of tax either on capital gains or on stock transfers, or on beer or on chewing gum?

M. *The distinction between short-term and long-term gains.*—Mr. Paul stated: "Gains on assets held less than a year are as current as other types of income earned during the same period." But are they as regular and as persistent? In fact, Mr. Paul refuted himself on the same day, March 30. In answering Representative Knutson at the hearings, Mr. Paul said: "Nobody can tell what the market will do in the future. That is the very nature of the stock market. It may go up or it may go down." Would Mr. Paul make an equally non-committal remark about a worker's wages or an employee's salary? A lawyer or an employee may have about the same income 5 years in succession. Can Mr. Paul find any stockholders that have capital gains 5 years in succession? Mr. Paul admits, "There is, of course, no exact dividing line between long- and short-term gains." He then states that gains on assets held for less than 1 year raise no accrual problem but gains on assets held for 2 years or more do raise an accrual problem. Is this not reasoning in circles? Does this not beg the question? Does the mere fact that an artificial accrual problem is thus created justify a different rate of tax? Mr. Paul still does not answer the practical problem. Why should a capital gain be subject to an 88-percent rate as income tax on one date and only a 25-percent rate on capital gains tax 2 days later, that is, 1 day before and 1 day after some imaginary dividing line between long- and short-term gains, whether 12, 15, 18, or 24 months?

N. *Concerning the rate on long-term gains.*—Mr. Paul states that the 15 percent rate on capital gains was enacted in 1938 when income surtaxes were lower and therefore that the tax on capital gains should increase to 30 percent to bring it in line with other income. This is merely an example of the consistency in error. Why does Mr. Paul fail to state that in 1938 capital gains tax rates were drastically reduced, while income-tax rates remained unchanged and high—up to 75 percent? If capital gain is not income there is perfectly good reason for not increasing the rate now. And capital gain is not income, as Mr. Paul indicated in his forecast above that "the market will either go up or go down."

O. *On the segregation of losses from other income.*—Officials stated: "Both H. R. 6358 (the Boland bill) and the Treasury recommendations (now in the House bill H. R. 7378) would eliminate the deductibility of long-term losses from income." However, there is this vital difference. The Boland bill, urged now is consistent. Losses are not deductible, because gains are not taxable under income-tax rates. But the House bill H. R. 7378 would tax capital gains as income and disallow losses as deductions from income. Shall the Treasury eat its cake and have it too? Heads, the Treasury wins; tails, the taxpayer loses.

VIII. ANALYSIS OF HOUSE BILL H. R. 7378 WHICH REPLACED BOLAND BILL H. R. 6358 IN LIGHT OF OFFICIAL FIGURES AND PAST EXPERIENCE

A. *The House bill would virtually abolish the distinction between long-term and short-term gains.*—The House bill provides that long-term losses may be offset against short-term gains and that short-term losses may be offset against long-term gains, and further that long-term losses should be regarded as short-term losses in that they may henceforth not be deductible from income. Thus, the House bill, at one swoop, abolishes the distinction between long- and short-term gains. After the many successive amendments to the act, since 1921, the House bill now provides for the first time that, though arbitrary, and artificial, the several distinctions, between long-term and short-term holdings be abolished.

Yet at the same time, the House bill makes the opposite provision that a 15 months' holding period distinguish long-term gains from short-term gains. Is this not inconsistent and illogical What is the object? Is it to increase revenue? Treasury statistics for 20 years prove that the short-term gains were taken only by taxpayers in the low brackets of income. The rich paid little or nothing on short-term gains. Does the House bill therefore offer this provision in order to reduce revenue? For reduce revenue it will. As the income-tax rates are now sharply to be raised, short-term gains taxable as income will be taken even more sparingly than in the past. The tax will not reach the rich. Is this the intent?

This is not theory. This is fact. Should not this committee ask its experts what figures support this new and self-contradictory proposal? Even when the Vichy government introduced the capital-gains tax on France it made no discrimination between short-term gains and long-term gains. The period was reduced to 3 months and the rate to 10 percent. After 3 months there was no tax.

B. *The House bill provides that long-term losses should no longer be deductible from income, but treated like short-term losses, not deductible from income.*—This is not a new proposal. It was legislated in 1916 and repealed in 1917. It was legislated in 1934 and repealed in 1938. Now it is being proposed a third time. Why? Is past experience of no value?

Apparently, under the new provisions, the House bill no longer considers long-term capital gains as income. This theory is correct. For Treasury statistics prove abundantly that capital gains are neither regular nor persistent. And to support the theory that long-term capital gains are not income, it is now provided in the House bill that long-term losses should not be deductible from income. They are put into a different category from income. Therefore, why does the House bill now provide to raise rates on long-term capital gains just because it provides to raise rates on income?

C. *The House bill provides the reduction of the holding period from 24 months to 15 months. This reduction is without value to the Treasury. The 15-month period is harmful to our war finance.*—In the current rapid movements of world history, how few can take a commitment for 15 months? The Treasury says it is on a 24-hour basis. Is it fair to expect the investor to be on a 15-month basis? Can the committee's experts prove that under the House bill the 15-month period would produce more revenue under the 25-percent rate than did the 24-month period under the 15-percent rate? The revenue-producing factor is not the shorter holding period, but the lower rate.

Property tied up by contract automatically depreciates in value. The holding period, whether 24 or 15 months, tends to depreciate market prices substantially, whether of real estate, farms, or shares. Therefore, the Treasury today collects less in inheritance or gift taxes than it might if there were no holding period or if there were a free market for such assets.

Besides, we need planes, tanks, and guns now, not in 15 months from now. We are talking about collecting income taxes weekly. Why defer collecting capital-gains taxes by 15 months? The tax that the Treasury may collect in 15 months, if the market stays up, is of less value than the tax that the Treasury will surely collect on short swings in the market, today, tomorrow, every day, if the holding period is abolished.

D. *The House bill provides a 5-year carry-over. This would completely destroy the Treasury receipts from capital gains.*—From 1917 to 1940, for the country as a whole, there was only one 5-year period—1925-29—which showed that the Treasury reported total net capital gains for every year of the period. The

rate on long-term gains was then only 12½ percent. Figures submitted by the present witness to the Senate Finance Committee on H. R. 9862 on March 18, 1938, show that, beginning with 1917 and ending with 1936, most of the 5-year periods showed net losses. The Treasury would therefore have received no taxes. The period from 1925 to 1929 constituted the exceptions.

These results are confirmed by statistics of a sample of wealthy taxpayers. The report, Million Dollar Incomes (Government Printing Office, 1938), pages 40–43, prepared for the Joint Congressional Committee on Taxation, shows that for the 5 years of the boom period, 1925–29, there were for these particular taxpayers net capital gains; but that in the remaining 15 years, namely, 1917–24 and 1930–36, there was a net capital loss. Furthermore, the report of Hon. Fred M. Vinson, chairman, Subcommittee on Taxation, to Hon. Robert L. Doughton, chairman of Committee on Ways and Means, January 14, 1938, shows for all taxpayers the following tax receipts or deductions (p. 90):

Tax deductions for capital losses, 1930–32	$184,000,000
Tax receipts from capital gains, 1933–35	118,000,000
Net tax loss for 6 years	68,000,000

E. *A 25 percent rate has proved unproductive in the past.*—The reasons are obvious. Assume that a stock earning $3 per year is selling at $100. The earnings rise by $3 to $9 and the price rises to $150. The owner sells and invests the proceeds in another stock earning $9. The capital gain would be $50, and at a 25 percent rate the tax would be $12.50, or over four times the $3 increase in earnings. Obviously, an income-tax rate of 400 percent for the mere privilege of transferring to another security would be not a tax but a fine. It would be a capital levy. It would put a penalty on good management and on growth of business.

There is evidence from official statistics to show that in the past a 30 percent rate in certain income brackets, a rate close to the proposed 25 percent, produced little revenue, certainly much less revenue than the lower rates in effect at the time for other income brackets.

In 1938, for example, a surtax rate of 30 percent applied to the $50,000 income bracket. Short-term gains were therefore taxed at that rate, but long-term gains were taxed at the 15 percent rate. What does the official record show?

Income bracket	Short-term gains taken	Long-term gains taken	Percent short-term to long-term
Under $5,000	$45,800,000	$30,300,000	151
$50,000 to $100,000	6,600,000	20,800,000	32
Ratio of high-bracket to low-bracket gains	*Percent* 14	*Percent* 69	

Source: Statistics of Income, U. S. Treasury, 1938, table 4, p. 10.

Here you have tangible evidence that long-term gains under the low rate, 15 percent, were much greater than on the short-term gains under the high income-tax rates, 30 percent—three times as great. What evidence have the tax experts to believe that the situation will be different in 1942?

An even more sensational demonstration is available from another Government document, the Vinson report, 1938, table 6, page 86. This shows the 1934 results for capital gains classified by period of holding and by income rates. It was in that year that the capital gains rates had five holding periods for each income-tax bracket. The lowest holding period was under 1 year. The highest was over 10 years.

A rate near to the House bill's new 25-percent rate was the 33-percent rate which, under the 1934 law, was applicable to capital gains taken during the period 2 to 5 years by persons with incomes over $100,000. In this holding period of 2 to 5 years, capital gains were considered as 60 percent of income. The income-tax rates in that year ranged from 52 percent on incomes of $100,000 to 59 percent for incomes over $1,000,000. Therefore, if capital gain is regarded as 60 percent of

income, then the capital-gains rate payable would be 31 to 36 percent. What were the results under the 1934 law? What were the capital gains by periods for incomes of $100,000 and over?

Actual 1934 capital gains on incomes over $100,000 by periods of holding:

Holding period	Capital gain regarded as income up to—	Average rate of tax on capital gains	Capital gains taken	
			Thousands of dollars	Percent of total
	Percent	*Percent*		
Under 1 year	100	55	6,772	13.8
1 to 2 years	80	44	4,143	8.5
2 to 5 years	60	33	138	.3
5 to 10 years	40	22	2,077	4.2
Over 10 years	30	16	34,396	70.2
Not stated			1,480	3.0
Total			49,006	100.0

Apparently the 33 percent tax rate produced only one two-hundred-and-fiftieth as much Treasury revenue as the 16 percent tax rate. Most of the yield, 70 percent, was derived from the 16 percent tax rate. Yet the House bill now proposes a 25 percent rate. What tangible evidence can the tax experts adduce to prove that in 1942 the 25 percent rate will not again be as unproductive?

The question may be regarded from another angle. Take again the above table 6 in the Vinson Report (1938) showing the 1934 returns and compare the yields in the holding period of 2 to 5 years for the several classes of incomes. In the period 2 to 5 years, 60 percent of the capital gains were considered as income.

Income classes	Income-tax rate	Average capital gains tax rate	Capital gains taken—	
			Thousands of dollars	Percent of total
	Percent	*Percent*		
$0 to $5,000	4	2.4	6,206	31.0
$5,000 to $25,000	4–17	6.0	9,397	47.0
$25,000 to $50,000	17–30	13.0	3,293	16.5
$50,000 to $100,000	30–52	24.0	962	4.8
Over $100,000	52–59	33.0	138	.7
Total			19,995	100.0

Here is a progressive decline in capital gains taken as the tax rates rise. At the 33-percent rate the amount of capital gains taken was the lowest of any income bracket. The 13-percent rate produced 24 times as much and the 6-percent rate 68 times as much. Let the committee's experts adduce any statistics to support the provision of a 25-percent rate on the basis of the returns for 1934. The House provision of a 25-percent rate would seem to have been unproductive and futile in 1934. Why not in 1942?

Similar evidence may be adduced for the years 1926 to 1933 (Vinson report, table 8, p. 88). This table shows that, for the classes of income of $1,000,000 and over, short-term capital gains, taken under the graduated income-tax rates, averaged around 12 percent of total gains and fell as low as 7 percent. The long-term capital gains taken at the lower flat rate of 12½ percent averaged 88 percent of total gains and were as high as 93 percent.

Now capital gains are taken at the option of the taxpayer. You catch flies with honey, not with vinegar. The higher the rate the less are the gains taken. The lower the rate the more are gains taken. If the capital-gains tax were regarded as a sort of transfer tax and a low rate set accordingly, the yield should be very great, probably in excess of the maximum ever collected under higher rates. The automobile makers built up a vast business on the principle of lowering prices and increasing volume and profits. Let the Senate Finance Committee note this principle.

The present inactivity of the market and the low volume of transactions is an illusion of peace and quiet. If one analyzes stock transactions in the light of the

Treasury returns, it is evident that most of the stock-exchange transactions are for the account of small people. To the big investors and stockholders the stock market is virtually closed today. They cannot buy and sell under the existing rates of tax on short-term gains. An analysis of the transactions of a few stock-exchange firms will support this view. The same illusion applies to the big holders of real estate or farm lands. These markets are artificial, narrow, and confined to a class of small people who know little. Therefore, the market movements are erratic, like that of dead frog muscle touched by an electric wire. But if the fear of inflation becomes widespread the large holders of cash and bonds will rush to buy shares, but few stockholders will sell shares. A buyers' panic should ensue. Stock prices will skyrocket. This is exactly what happened in Vichy-France, under the original capital-gains tax rate of 30 percent imposed in 1941 for the first time in the history of France.

F. *Official statistics do not support the House bill.*—The statistics presented above provide evidence that the terms of the House bill are refuted by experience and past records. For these terms there seems to be no basis. The Treasury is unable now to make any estimate of receipts from the tax on capital gains. In fact the very method of publishing the returns from the capital-gains tax makes it impossible for the Treasury to prepare any estimates. It was not until 1938 that capital gains were segregated into short-term and long-term, but even then capital losses were not so segregated. The Treasury's published data affords no evidence that the present proposals would be useful, practical, or revenue producing.

Capital gains are the folklore of Government finance, shrouded in mysticism. Therefore the witness very respectfully recommends that the provisions of the House bill for a capital-gains tax be replaced by the provisions of the Boland bill which are supported by official statistical data and factual evidence.

G. *What data must the Treasury furnish for Congress?*—Statistics of the capital-gains receipts are merged in the record with the regular income tax. Congress is therefore in a position of a surgeon, operating on the body politic in the dark and without knowledge.

Since 1917 there have been a great number of variations in the capital-gains tax. We changed the holding period. We separated long- and short-term gains and losses. We permitted, prohibited, and then limited deduction of losses from gains, long term and short term. There is no clear record of what were the results of the various procedures. Imagine a physician changing treatments and not recording the results. We have changed the rate from 12½ percent up to the maximum income-tax rates and down again to 15 percent, but no one has compared the effect of such variations in rate on the volume of tax receipts. We have had carry-over losses for varying periods. The data in the Treasury has not been studied or presented. There can be no intelligent legislation on the capital-gains tax until the facts are presented.

The writer had the task of a fiscal Sherlock Holmes, piecing together evidence which however has proved irrefutable. A full record of the facts would make the argument unnecessary.

The Senate Committee on Finance should insist on having for the entire period of capital-gains-tax legislation, 1913–40, adequate statistics to show the effect on the volume of revenue as several features of the law were changed. The Treasury should furnish the following data:

(*a*) Revenue receipts and revenue losses to the Treasury, through deducting capital losses from regular income, 1917–40.

(*b*) Short-term capital gains, short-term capital losses, and net excess, 1917–40, showing the features of the legislation then effective with respect to rate, holding period, offsets, etc.

(*c*) Similar data on long-term capital gains and losses.

(*d*) Both the long-term and short-term gains and losses should be classified by income groups. This would show the effect of rising tax rates upon the volume of Treasury receipts from the various groups.

H. *Where is the supporting data?*—Where are the facts and figures that would support the assumptions of the House bill, H. R. 7378, that—

1. Capital gains recur regularly like ordinary income.

2. So-called long- and so-called short-term gains differ in origin, in nature, in motive, and method of realization.

3. A 5-year holding period will end with a net gain for the stockholders and the Treasury.

4. Higher rates produce more revenue and lower rates produce less revenue.

5. H. R. 6358 (the Boland bill) will produce less revenue than either the present law or the House bill, H. R. 7378.

6. The House bill, H. R. 7378, would produce more revenue than the present law or than H. R. 6358 (the Boland bill). Such facts and figures cannot be submitted because no such data exists.

I. *The terms of the House bill violate basic tax principles.*—The proposals on the capital-gains tax violate tested tenets of taxation, namely:

1. The tax should produce revenue. High rates of tax on capital gains never did and never will.

2. The tax should do little harm. The proposed rates will again in the future, as in the past, boom the market in real estate and in securities, and will again, as in the past, lead to a violent collapse.

3. The tax yield should be certain. The yield from this tax is so uncertain that the Treasury has never yet been able to approach any reasonable estimate.

4. The tax should not destroy its source or the source of other taxation. The proposed rates would hamper individual risk taking and thus reduce future income-tax receipts.

J. *The House bill will, if enacted, probably cause a wild inflation in real estate, farm land, and securities.*—The proposed high rate of tax on long-term gains and the prohibitive rate on short-term gains places a penalty on the seller but none on the buyer. The Treasury will thus create a one-way market. If there is a free market, so that persons can sell without any penalty or with a slight penalty, the market could be kept in equilibrium between sellers and buyers. But if the market should consist mostly of buyers and of few or no sellers we shall repeat on an aggravated scale the experience of 1929 and 1932.

The capital-gains tax deterred people from selling in the late twenties. The main European stock markets, in London, Paris, Amsterdam, Brussels, etc., were free of a capital-gains tax. All these markets turned down, beginning with the spring of 1928 to the spring of 1929. The American markets, restrained by a capital-gains tax, carried on the rise into the summer of 1929, and at an excited, hysterical speed. Then came the collapse, which ran for 3 years into the summer of 1932. The Dow-Jones industrial index of American shares declined to one-tenth the peak levels, but European shares to one-half or one-third only. The collapse brought in its train world-wide unemployment, social disturbances, the rise of Nazism, and then the war. Of course, the capital-gains tax was not the sole factor in this sequence of events, but it was an important contributing factor.

It takes no prophet to predict that the coming boom in property and the coming collapse under the proposed restrictive capital-gains tax will exceed by far that of the period of 1929–32. The higher rates of tax on both long-term gains and short-term gains will be even greater deterrents to selling on the rise. Now, with the rapidly rising debt the threat of the depreciation of the dollar is greater than ever. Let the Senate Finance Committee consider carefully the terms of the House bill on capital gains. Similar provisions have in the past proven to be not merely economically futile but fiscally unproductive. The provisions will threaten a wild inflation and a perilous collapse in our national life. How grave is your responsibility for wise action!

IX. CONCLUSIONS CONCERNING THE HOUSE BILL

Twenty-five years' experience justifies the repeal of the capital-gains tax. But the Government needs revenue in wartime. There are revenue-producing possibilities in a low rate of tax on capital gains—a sort of high transfer tax on switching securities. The Boland bill (H. R. 6358) exploits these revenue-producing possibilities. It will simultaneously provide great additional benefits. The provisions of the House bill would further reduce revenue and would have very serious restrictive effects on the market for farm land, for real estate, and for securities. They threaten dangerous inflation. The provisions of the Boland bill should be included in the Senate tax bill and remain in effect for the period of the war. The Treasury's own statistics support this conclusion.

In filing this brief to support the oral statement, may I say that it refutes the major provisions of the House bill, H. R. 7378. This brief shows that the 15 months' holding period is artificial and prevents realizing of gains at income-tax rates. It shows the unsoundness of segregating short-term capital gains from long-term capital gains. It proves that the House bill cannot produce any revenue. It shows that the right to offset losses, either long or short, against gains, long or short, must result in realizing losses, of which every portfolio has an abundance, in order to offset gains. Finally, it presents evidence that a 5-year carry-forward would, over the whole period since 1913, except for the period 1925 to 1929, have resulted in the wiping out of revenue from the capital risk tax.

At the House hearings Representative Disney, of Oklahoma, stated:

"I should like to make this observation, Mr. Chairman. Mr. Robertson said to me privately awhile ago that when the committee gets into the subject of capital gains we get into a fog. It seems to me that it would not be a bad idea for a subcommittee of two or three members to try to get to the bottom of his subject for the benefit of the rest of the members of the committee."

The Committee on Finance may be convinced by the avalanche of statistics supporting the terms of the Boland bill, H. R. 6358, and destroying the assumption on capital gains in the House bill 7378. If the committee is not convinced, may I respectfully suggest that perhaps your committee may find Representative Disney's suggestion of value? Such a subcommittee of the Senate Committee of Finance would realize on study that there are abundant statistics to support the provisions urged above. The bill on taxing capital gains introduced by the late Honorable Patrick J. Boland might well form a sound basis for a tax on capital risks, which would be productive of revenue, would unfreeze the securities markets, and revive the spirit of enterprise now rapidly withering.

ELISHA M. FRIEDMAN.

NEW YORK, *August 7, 1942.*

ADDITIONAL STATEMENT OF ELISHA M. FRIEDMAN, OF NEW YORK, N. Y.

THE EFFECT OF PROPOSED CORPORATION TAXES WITH SPECIAL REFERENCE TO PUBLIC-UTILITY COMPANIES

Mr. FRIEDMAN. If you will be kind enough to give me a few minutes more, I should like equally rapidly to go through my public-utility statement.

The CHAIRMAN. All right, sir.

Mr. FRIEDMAN. Perhaps a historical perspective will enable us to see more clearly both our problems and the proper political attitude toward them.

About 100 years ago, and as a result of the Napoleonic Wars, the world was in a state of instability, almost matching the present. It was between the two revolutions of 1832 and 1848. In England, the Chartist agitation resulted in riots in Birmingham and Newport. The National Chartist Convention publicly urged the use of force. In France, there were revolts in Paris and Lyons, and an attempt to assassinate King Louis Philippe. In Spain, the Carlist War was on, and there were insurrections in Madrid, Aragon, Andalusia, and Catalonia. In Portugal, uprisings were chronic. In Italy, the new revolutionary society, Young Italy, made the country seethe. In Germany and Austria, the Metternich system or reaction and repression was in full force.

At that time—1838—the English poet William Wordsworth, in sonnet IV, Dedicated to Liberty and Order, wrote:

> Blest Statesman He * * * whose eye
> Sees that, apart from magnanimity,
> Wisdom exists not; nor the humbler skill
> of Prudence, disentangling good and ill
> With patient care. What tho' assaults run high,
> They daunt not him who holds his ministry,
> Resolute, at all hazards, to fulfill
> Its duties—prompt to move, but firm to wait—
> Knowing, things rashly sought are rarely found;
> That, for the functions of an ancient State—
> Strong by her charters, free because inbound,
> Servant of Providence, not slave of Fate—
> Perilous is sweeping change, all chance unsound.

With that as an introduction, I should like to go rapidly through the utility brief.

Senator CONNALLY. He was a fine poet, but he never sat on the Finance Committee.

Mr. FRIEDMAN. I beg your pardon. What is that?

Senator CONNALLY. I was just carrying on a little soliloquy. Mr. Wordsworth was a fine poet, but he never sat on the Finance Committee.

Mr. FRIEDMAN. Undoubtedly, he would have considered it a high privilege and would have fortified a poet's insight with knowledge.

Owing to lateness and the limitations of time, I shall summarize a brief containing supporting tables of statistics and charts which I hope you will permit me to file for study by the committee and its experts.

I. INTRODUCTION

The House bill, H. R. 7378, despite exhaustive hearings, has left the tax on utilities as a serious threat to the industry, to its usefulness during the war, to its survival after the war, and to the whole concept of private enterprise. Probably never before in its history has the industry faced such a critical moment. This statement will present the facts, describe the conclusions, outline the causes, and take the liberty of suggesting certain remedial provisions to avert the threat in the tax bill as it now stands.

II. FACTS

A. *The Secretary of the Treasury enunciated a sound principle of taxation.*—"A tax which dips too deeply into the income of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence."

This principle is the heart of the utility problem. Unfortunately, H. R. 7378 ignored this sound principle enunciated by the Secretary.

B. *The utility industry is unique for the high investment per dollar of sales.*—Utilities require about eight times as much fixed capital per dollar of annual gross earnings as the average industrial company. A tax, therefore, may be fair to manufacturing companies and grossly unfair to utility companies.

C. *The utility industry has its rates fixed by Government authorities and is allowed only a small net return.*—Therefore sharp increases in taxes have a unique effect not evident in industrial companies.

D. *Utilities are unique also because their volume of sales has not expanded greatly through war demands.*—Indeed, the war has disorganized the profitable part of their business—residential and commercial load—through dim-outs, curtailment of nonwar production, and discontinuance of important lines, such as sales of automobiles, home appliances, and so forth.

E. *Utility rates have been declining since August 1939, while other commodity prices have been rising.*—The O. P. A. put ceilings on industrial commodities. The utility industry has had ceilings for a long time.

F. *Utility taxes have increased markedly.*—In the last decade the percentage of gross revenues paid in taxes has doubled and the balance available for return has correspondingly declined. Utilities are

unique also in that they are subject to special taxes not paid by industrial corporations, such as energy tax.

G. *Utility costs have risen but utility selling prices have fallen.*—Taking 1939 as 100, taxes have risen 45 percent; equipment and construction material 12 percent; labor costs also have risen. At the same time rates per kilowatt-hour have actually fallen about 3 percent.

H. *Utility net earnings have been declining while industrial net earnings have been rising.*—The industrial companies experience sharp rises in selling prices and likewise sharp increases in volume.

Not so the utilities. During the past 6 years net income before taxes has risen 1.5 times; Federal income and excess-profits taxes have risen 6.0 times; and net income after taxes has actually fallen to 0.66. Under the taxes on corporate income and excess profits a representative group of operating electric utility companies, like Consolidated Edison (N. Y.), Consolidated Gas (Baltimore), Pacific Gas & Electric, and so forth, would, if applied to the 1941 earnings, have shown a decline of 33 to 53 percent from such actual reported net earnings after taxes of 1941. Such earnings after taxes under H. R. 7378 would be below reported net earnings after taxes during the base period of 1936–39 by about 33 percent.

I. *Utilities have shown long trend of falling rates, falling earnings, and rising taxes.*—They virtually have been a tax-collecting agency for the Government. Should not they be kept alive if only for this purpose, to say nothing of their peculiar significance in the indispensable contribution to war production?

J. *Utility taxes discriminate against privately owned utilities and favor publicly owned utilities.*—The customers of the latter are not bearing their share of the war burden.

III. WHAT ARE THE CONSEQUENCES OF THE FEDERAL TAXATION ON UTILITIES?

A. *The utilities uniquely have been hurt by the war and not benefited.*—Increased sales due to the war are almost entirely in the low-priced services supplied to industries. The increased demand required expansion of plant and equipment without a corresponding increase in gross earnings.

B. *Utility earnings are less than the reasonable return allowed them by the courts and commissions.*—The tax provided in H. R. 7378 sets a limit of 5 percent earnings on capital exceeding $200,000,000. A 45-percent corporation tax then leaves a return of only 2.75 percent. This is not a reasonable return as defined by courts and commissions. Such a return will not attract additional capital. How can even a preferred dividend of 5 or 6 percent be paid?

C. *The taxes in H. R. 7378 would further reduce earnings and dividends.*—Important operating companies like Consolidated Gas, Public Service of New Jersey, and Pacific Gas & Electric would under this bill show net earnings after taxes in 1941 lower than in the base years 1936 to 1939 by 33 percent or more. For example, for the Public Service Co. of New Jersey, Federal income taxes took about 25 percent of the net income in 1939. Under H. R. 7378 this percentage will rise to about 75, and if local taxes are included—84 percent. In 1941 the company earned $2.04 per share and paid $1.95 in dividends. Unless the provisions of H. R. 7378 are modified there will be little or nothing left for its common stockholders.

For the industry as a whole net income will decline 30 percent below 1941. Dividends will have to be cut. There will be less left to the stockholder for the Government to tax. We tax the same value twice—once as corporation earnings and again as dividends to the stockholders. Was it not Chief Justice Marshall who said "The power to tax is the power to destroy"?

D. *The tax on corporation income is regressive.*—A tax of 45 percent on the earnings of a corporation is virtually 100 percent tax upon the smallest stockholder on the first 45 percent of the potential dividend. When that dividend is reduced or passed it is 100 percent taxation on the whole dividend. Would any government dare to propose such a plan of taxation to the small shareholders directly? If such rates would be unjust and intolerable, if levied directly and openly, are they any less unjust and intolerable if levied covertly and by indirection?

The income of a large utility is held by small people. For example, of the 634,000 stockholders of American Telephone & Telegraph Co. at the end of 1941, 79 percent owned less than 25 shares each, now worth $3,000 and now paying $225 per year. The rate will have to be reduced from $9 to $6. This is a 33 percent cut, or the equivalent of a 33-percent prior tax, but under the individual income tax the 33-percent tax is applicable only on incomes at $20,000. Are the holders of 25 shares of American Telephone to be taxed at this rate?

A large corporation has many small stockholders. The ability to pay is not in the corporation, it is in the stockholders. Discrimination via corporations is unrealistic. According to the T. N. E. C. report there are about 9,000,000 stockholders. Over 90 percent of these, representing say 18,000,000 voters, had less than $5,000 of dividends in 1937. Merely because they are not organized, like farmers and trade unions, shall their rights be ignored? If they are ignored, what a powerful incentive for prompt organization as a political pressure group to enforce their rights and to resist those who are kicking them about like a houn' dog.

Senator TAFT. Would that they did organize.

Mr. FRIEDMAN. It is these small people whose earnings will be cut by 33 percent, 50 percent, or more, if the provisions of H. R. 7378 go into effect, and tax a corporation 45 percent on income and 90 percent on excess profits. Every university, hospital, and charitable foundation, now tax-exempt, will become taxable through the corporation tax. Who will suffer? The sick poor in the privately owned hospitals and the free, poor students of privately endowed colleges.

E. *The rise in the rate of corporation taxes has caused switching out of the corporation form into the partnership form.*—This is possible in a small business, but can the great utility companies become partnerships in order to avoid unjust taxes?

F. *The tax on corporation income favors debt against stock, unsoundly financed companies against soundly financed.*—Earnings available for bond interest are taxable only when in the hands of the bondholder. It is not taxed with the corporation. But earnings available for preferred-stock dividends are taxed twice—once through the corporation and then through the stockholder. The S. E. C. and other Government departments have been urging corporations to replace bonds with stocks. Now the tax authorities proceed to punish those who have conformed to the Government's wishes.

G. *The proposed taxes will prevent expansion of facilities necessary to meet war demands.*—When dividends are cut, how can corporations sell new stock?

H. *Even bond financing becomes difficult.*—S. E. C. announced strict standards under section 7 of the Public Utility Holding Co. Act of 1935. The proposed tax will prevent a utility company from meeting these standards and borrowing.

I. *The tax is a threat to the war effort of the utility companies which are supplying power and light to the war industries.*

J. *The utility companies will be weakened.*—(1) Not only are common stocks reduced in earnings but the margin for the senior securities shrinks. Is there no way of raising an equivalent amount of revenue without weakening the economic structure of society?

(2) Corporate margins and reserves will be reduced or wiped out. These reserves are necessary for adjustment during the post-war period. Where will the utility corporations find a margin of safety or flexibility for readjustment to peace conditions?

(3) The liquid position of corporations will become impaired. As prices rise inventories cost more. Balance sheets show a weaker net current position because cash declined and borrowings rose.

K. *The tax proposals will force a trend to public ownership.*—If the companies cannot finance they must borrow from the Government. Thus the Government may have to take them over. Publicly owned utilities pay no taxes and the rest of the community must take over the burden.

L. *The morale of the private investor will be shaken.*—When the tax bill began to assume shape the investment advisory services warned their clients about the risk in utility securities and advised their sale.

(1) What are the effects on market value? One month after the Treasury proposals were submitted to the Ways and Means Committee the New York Stock Market declined over $2,000,000. The best stocks, like American Telephone, broke badly. Speculative bonds rose to new highs. The tax was discriminatory against the utilities and in a free mobile market which responds readily to political and economic forces, the results were obvious. The utilities were hurt even worse than the average. In the year ending July 1, 1942, industrial common stocks declined 15 percent, but the operating utility common stocks declined 28 percent. Similarly, industrial preferred stocks declined 7 percent, but operating utilities preferred stocks declined 23 percent. The market was intelligent and sensitive. It moved as the tax forces dictated. Such shrinkage in value confirms the specific, unique, and discriminatory tax effect on utilities of the tax bill, H. R. 7378.

(2) The Treasury will therefore lose money on inheritance taxes which used to average about $300,000,000 a year. The tax rates may be increased to make up the shrinkage but that merely results in more rapid confiscation.

(3) The decline in market prices resulting from the proposals on corporation taxes has virtually been a capital levy on the country. But the capital levy did not bring any receipts to the Treasury. The values just evaporated.

If the percentage of shrinkage on the New York Stock Exchange were applicable to all other income-producing properties, such as real

estate, and so forth, the loss to the people of the United States would be over $10,000,000,000 in market value. Strikingly enough Great Britain, with a burden of taxation far heavier than in the United States, has followed a more rational system of taxes on corporations, has shown no such results. The London Stock Market today is somewhat higher than in August 1939. The New York Stock Market is 39 percent lower.

(4) What are the effects on United States Government bond subscriptions? When a tax bill strikes $10,000,000,000 from the market value of the assets of the people of the United States must not Government bond subscriptions suffer? When the substantial part of a lifetime accumulation is whittled away in 1 month by a thoughtless tax bill, do you increase or decrease Government bond subscriptions?

M. *The tax bill will not check inflation.*—Not all taxes are deflationary, nor are all loans inflationary. To check inflation the purchasing power of the population must be limited, and this has been accomplished abroad directly by rationing, by control of prices and wages, by compulsory savings, and by sales tax reducing the excess purchasing power. Practically every country in the world has a sales tax. We can do likewise, if we but will. The taxes on corporations will not reduce consumption. They will reduce production. The tax bill does not deflate commodity prices and the nonwar economy. It deflates only stock prices, and thus produces an illusion of deflation.

IV. WHAT ARE THE CAUSES?

A. *The theory of the tax is unsound.*—In Great Britain the corporations pay a tax equivalent to the normal individual income tax, only because this tax is deducted at the source. The stockholder does not pay his normal tax a second time. He pays only the supertax. We used to follow this British practice until 1936. We taxed corporations on income and therefore did not levy a normal tax on dividends. True, the tax on corporate income was higher than the normal tax on individual income.

In 1936 we began to tax both the corporate income and the stockholders' normal dividends. The pickings looked easy. We then raised the corporation income tax. Then when we raised it as high as we could, we invented the idea of a surtax on corporations. Even the majority report of the House Ways and Means Committee (1936) dissented: "This is a new principle which has never been used in this country, and therefore your committee is recommending only a very moderate graduation." It was 1 percent. You remember the story of the camel and the Arab's tent.

Now the tax is 45 percent, showing the error of compromising on a principle. The minority report of the House committee criticized the measure because "it failed to look beyond the corporate entity to the millions of stockholders, most of them of small means, who actually make up the larger corporations." The minority report of the Senate Finance Committee likewise commented, "it discriminates against the small investor in the large corporation and in favor of the large investor in the small corporation."

The error of taxing the same income twice had little serious effect when the rates were low, but when, as in H. R. 7378, the tax on corporation incomes is raised 45 percent this error in practice principally produces a grave effect on the whole economy.

No country in the world has the rate of taxation on corporation incomes so high except for the 50 percent rate in Germany, which has no excess-profits tax. In no country in the world is there a surtax on corporations except in Canada. Apparently they copied our bad example. We did not, however, copy the good tax practice of the Canadians. They have a lower base for the individual income tax and a higher normal rate. They withhold the tax at the source and have a compulsory savings plan, payable as a proportion of the income tax, and collected at the same time. They have a sales tax. They have no capital-gains tax. The tax laws in Canada make special provisions for special situations in various industries—as, for example, lumbering. Its Department of Finance has wide latitude in easing hardships for individual corporations.

B. *The corporation is a faction as a taxpayer.*—The individual is the real taxpayer. The corporation is a fiction as a taxpayer and in general. Even the Government thinks so. In prosecutions under the antitrust law the Government goes behind the corporation and seeks out the directors and officers for fine and punishment. Again, the corporation is engaged in production. Production should be encouraged and not checked. The individual is a consumer. And it is consumption which should be checked, not encouraged. Taxes on the income of the corporation should really be levied, as in England, on the individual stockholder.

C. *The utility industry is unique.*—In the years 1936-39 the average revenue per kilowatt-hour was 2.20 cents as against 1.90 cents in 1941. Again, it is subject to unique taxes. For example, the Consolidated Edison of New York pays a public-utility excise, or local tax; a conduit-company excise, or local tax; a public-utility gross-income tax, a special State tax; and an electrical energy tax, a special Federal tax.

These four special taxes not applicable to industrial companies amounted to 20 percent of all the taxes. What other industry is subject to corresponding specific discriminatory taxes?

D. *The uniform system of accounts prescribed by commissions permitted deduction of income tax and other taxes from operating revenue.*—When rates on corporate income were low and no excess-profits tax was in effect, a rise in taxes could be passed on to the consumer. Under H. R. 7378 this is not possible.

V. WHY THE UTILITIES NEED RELIEF

A. *Utilities are vital to the prosecution of the war.*—There can be no production of steel, tanks, and airplanes without adequate electric power.

B. *Utilities must raise new money.*—Companies serving war industries and military camps have priority and must expand. If the tax on utilities impairs their financial position how can they raise any money for expansion?

C. *Public utilities are vital in the transition period.*—When the soldiers return, many will be unemployed. The utilities could make up deferred maintenance. Those which had not expanded during the war, because of lack of priorities, could catch up and even anticipate further needs. That is, they can, if they are financially sound. They cannot if indiscriminate taxes impair their soundness, strip the

companies of cash, weaken their credit, and prevent them from buying electrical machinery, copper and cement, which could reemploy many hundreds of thousands of returning soldiers.

D. *The utility industry is vital to the country's economic life.*—The economic history of the United States can be spelled out in terms of the utility industry expansion. There is a close correlation between the kilowatt per worker, the number of employees in American industry, the national income, the productivity per man, and the standard of living. The report of the President's 1939 Committee on Labor Abroad showed that the number of days' work to provide the same minimum necessities to live was lowest in the United States. The utility industry was an important cause of such a condition.

E. *The Canadian Government has a successful tax policy.*—The Commissioner of Taxes at Ottawa, the Hon. C. Frazer Elliott, in a public address in New York on "The Nature and Growth of War Taxes in Canada," stated the principles they followed:

(1) "There should be a tax sufficiently heavy to recover to the taxing authority as much of the excess-profits and excess-spending power as possible, but leaving business always with a profit incentive.

(2) "The deadline for excess profits in the form of 100 percent tax in a capitalistic system is a frustration of its basic principles and a destroyer of hope, and without hope industry wanes. (The utility industry will not only lose 100 percent of its excess profits from 1936–39 but will even earn about one-third less than in that period.)

(3) "All business and the people of the Nation should be made to feel that there is a genuine bond of sympathy and understanding between the Government and them in relation to their numerous problems and that multitudinous though the affairs of the Government are, the problems of each industry may receive substantially individual consideration."

VI. WHAT ARE THE POSSIBLE REMEDIES?

A. *It should be possible to find a tax which is fair to the utilities.*—It should not be discriminatory. It should remove hardships resulting from applying to the utility-industry taxes suitable to and designed for industrial corporations. It should give them special relief to meet a special situation.

There are precedents. The American railroads are authorized to buy in their own bonds at a discount without paying capital-gains tax thereon in order to reduce their debt. In natural-resource industries, like petroleum and mines, depletion allowances are permitted which are unique to the industry. Why should not the utility industry have similar special recognition? Not as a favor, but as a right.

B. *Rate increases are impracticable.*—In many States utility rate contracts are with individual communities. Such a large number of rate contracts cannot be negotiated. Even where the State commission has authority to grant a blanket increase, lengthy hearings are required.

Furthermore, under high taxes on corporate income the shrinkage in earnings cannot be offset under the proposed 90-percent excess-

profits tax. To recover a $1 shrinkage in net income through the 45-percent corporate income tax would require a $10 increase in rates, of which the Government would get $9. The consumer cannot be thus burdened. He won't tolerate it.

C. *Pseudo remedies, like subsidies, are suggested.*—The O. P. A. objects to rate increases and suggests subsidies. The utility industry asks for no subsidy; it asks only for fair treatment, based on its unique character. It holds out no tin cup.

D. *Some technical proposals applicable to all corporations have been suggested.*—(1) Deduct income tax before the excess-profits tax is figured.

(2) Permit the credit base to be not 5 percent, as in H. R. 7378, but whatever the State utility commission now permits.

(3) In computing surtax and excess-profits tax, permit a credit against net income—

(*a*) Equal to preferred dividends;

(*b*) Equal to part of the common dividends;

(*c*) In order to permit meeting contractual obligations, to pay installments, and to reduce debt by sinking funds or serial retirements.

(4) *Tax publicly owned utilities.*—Federal revenue would thus increase. Unjust discrimination against privately owned utilities would be eliminated. Consumers of the publicly owned utilities would no longer be subsidized out of Federal funds.

E. *The facts justify a straightforward demand for unique treatment for a unique industry.*—(1) Utility companies should not be taxable until they have earned the fair return allowed by the courts and commissions. Such fair return is obviously net to the investor. Otherwise a tax by Congress could reduce this 6 percent fair return to 3 percent or 2½ percent. In this event the decisions of the Supreme Court would become just so much verbiage. The public utility commissioners would then become without power or responsibility, or even without significance.

(2) Rate reductions, both voluntary and by commission order, mean that excess earnings are not permitted. Rate reductions are virtually a 100-percent tax on excess profits. That is, excess profits are eliminated not by tax but by rate reductions. Therefore, the utilities should be justified in requesting different tax treatment.

(3) If the Congress insists on taxing utility companies, and if the court decisions giving the right to earn a fair rate is to be respected, that portion of the taxes on utilities which reduce earnings below such fair return should be passed on to the consumer either as a surcharge on the bill or as a surcharge on the rate. The Government will get the same amount of money as if it were paid by the corporation, that is, the stockholders, mostly small. The utility companies will merely act as a revenue collecting agent. The attached brief in support of this statement cites numerous decisions of the United States Supreme Court upholding the doctrine that taxes may be passed on to the public and that Federal income taxes are properly chargeable to operating expenses.

(4) Reduce or abolish the corporation tax for utilities and increase the tax on their dividends on a graduated basis, depending on the size of the dividend.

F. *The corporation tax and excess-profits tax on public utilities may be unconstitutional.*—If the Supreme Court allows a reasonable

return of, say, 6 percent, is it not unreasonable, illogical, and inconsistent for Congress to levy a tax which will reduce such fair return to 3 percent or less? Perhaps the provisions of H. R. 7378 reducing such return might be considered confiscatory and a violation of the fifth amendment to the Federal Constitution. A brief in support of this statement cites numerous decisions allowing a return of 6 percent plus or minus 1 percent. Other decisions also state that returns are confiscatory when they are less than 4.59 percent.

Another important question involved is if the Supreme Court can overrule Congress, has Congress the right to overrule the Supreme Court?

G. *Congress itself could limit its tax powers for a temporary period and for hardship cases.*—It may be possible to limit the Federal tax on the corporate creatures of the State whose rates are fixed and which compete with publicly owned properties which pay no Federal taxes.

Senator TAFT. The Utah Power Co. was here this morning. What is the main thing that makes the tax heavy on utilities?

Mr. FRIEDMAN. The utility commissions and courts have declared in various opinions that a 5- or 6-percent return is fair and reasonable. There are also other decisions and opinions that declare a 4½-percent return confiscatory, also 3 percent, and so on down the line. When you levy a 45-percent corporation tax and surtax on a company whose returns are limited to 5 percent you immediately cut them down to the confiscatory level. That is the story in a nutshell. Excess profits do not worry them.

Senator TAFT. This Utah company had excess profits.

Senator CONNALLY. The courts based that return on normal conditions; that is, peacetime regular profits. Don't you think these companies, in an emergency, in time of war, ought to make some contribution, even though it does not give them a normal return?

Mr. FRIEDMAN. Yes; unless the return is confiscatory. Authorities put a "ceiling" on rates and earnings in peacetime and should therefore put a "floor" under earnings in wartime. That raises a fundamental question. I think if we should follow the pattern of Great Britain, Belgium, and other countries who tax not corporations but the investors we could get the money from the utility stockholder without wiping out the utility companies. The tax at this rate, as Mr. Langley showed the House Ways and Means Committee, will prevent 40 percent of a sample group of operating utility companies from paying dividends on their preferred stock.

Senator TAFT. Mr. Friedman, it seems to me it is not much a company question. Take the common stockholders who have had a steady income and who are going to have to pay a very heavy tax, it seems to me the effect of this 45-percent rate will cut their income down to the point where they cannot pay any dividends. The company would be all right, but it would be just taking it out of the stockholders.

Mr. FRIEDMAN. Let us see. Here is the Public Service of New Jersey in a thickly populated area around Newark engaged in war industry—it has got to expand. That company's earnings will drop under the 1941 rate of $2.04 per common share down to zero, or close on to zero, and the

dividends will be passed. But the company says, "We have got to expand. Where are we going to get the money?"

You cannot get new money from sale of common stock with the dividends passed. You cannot get it from preferred stock because the preferred stock will be covered just about once. Then it will drop in price below the reasonable issue price for new preferred stock. Then what can the company do? It has to get it through bonds.

But the S. E. C. says, "Don't finance through bonds so heavily." Or it might be that a 45-percent tax will cut the margin of earning power over the interest charges so greatly that nobody will want to buy even bonds.

Then, besides that, after you have ruined the industry, where will you get the taxes from in the future? My suggestion is, in answer to Senator Connally, you can get the same amount of money not by taxing the utility corporation. You can get it in two ways: Either pass part of the corporation tax on to the stockholder on a graduated income basis and exempt all companies like utilities with fixed and rigid limits of earnings from certain aspects of the corporation tax and put a special graduated dividend tax on the stockholder, or the simpler thing to do would be to pass the corporation tax on to the utility consumer as you do on telephone and telegraph messages. You could add the equivalent of the corporation tax on utilities as a surcharge on the monthly bill or as a surcharge per kilowatt-hour.

The CHAIRMAN. All right, Mr. Friedman, thank you very much.

Mr. FRIEDMAN. May I thank you greatly for listening to the last of 18 statements and running so long beyond the adjournment hour.

(On subject of public-utility companies Mr. Friedman submitted the following memorandum:)

MEMORANDUM ON THE EFFECT OF PROPOSED CORPORATION TAXES WITH SPECIAL REFERENCE TO PUBLIC UTILITY COMPANIES, SUBMITTED BY ELISHA M. FRIEDMAN. NEW YORK, N. Y.

I. INTRODUCTION

The tax bill now before the Senate Finance Committee, despite exhaustive hearings by the House Committee on Ways and Means, has left the resulting utility tax as a serious threat to the industry, to its usefulness during the war, to its survival after the war, and to the whole concept of private enterprise. Probably never before in its history has the industry faced such a critical moment. It is not too late to take positive action.

This brief will present the facts, show the consequences, outline the causes, and propose remedies to avert the threat inherent in the tax bill as it now stands.

II. FACTS

A. *The Secretary of the Treasury enunciated a sound principle of taxation.*—The Secretary of the Treasury stated to the House Committee on Ways and Means: "A substantial share of the increased corporation tax should fall on excess profits * * *. A tax which absorbs excess profits still leaves the corporate taxpayer with sufficient margin of income for dividends and safety. On the other hand, a tax which dips too deeply into the income of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence."

This principle is the heart of the utility problem. A tax may seriously affect their very existence. Unfortunately, the bill presented by the committee ignored this principle.

B. *The utility industry is unique for high investment per dollar of sales.*—Utilities require about eight times as much fixed capital per dollar of annual

gross earnings as the average industrial company; because of stable earnings they could finance cheaply with bonds, thus keeping low both costs and rates; bonds constitute a larger percentage of total capitalization in utility than in industrial companies; bonds must have junior securities back of them; a heavy tax on corporate income reduces the earnings on preferred and common stock more sharply in case of heavy sinking funds; in fact, may endanger the safety of interest on the bonds; therefore a tax bill may be fair to manufacturing companies and be grossly unfair to the utility industry companies.

C. *The utility industry is again unique in that its rates and net return are fixed by authorities.*—The rates of return allowed for 358 public utilities—telephone, electric, gas, water, and street railway—averaged a relatively small amount over the 10 years to 1937, and declined from 7 to 5.93 percent.

Year:	*Combined rate of return*
1928	7.00
1932	6.81
1933	6.28
1937	5.93

A 50 percent corporation income tax would reduce the return to confiscatory levels. Industrial companies are not limited by law in selling prices and in net return and taxes therefore do not have as serious an effect. Furthermore, the utility industry is unique in that it is subject to special taxes, noted below, which are not paid by industrial corporations. An exception is made of them. They are different. Why should they be treated like industrial corporations in regard to the corporation income tax or excess-profits tax.

D. *Utilities are unique in that their volume of sales does not fluctuate greatly and that the war has disorganized some parts of their business.*—Residential and commercial loads declined for many and obvious reasons. The rise of the industrial load, paying low increment rates, does not compensate for increase in taxes. Such shift of loads requires new facilities for industrial business but still requires maintaining retail circuits and all their costs. The war has increased the taxpaying capacity of utilities but slightly. Yet, as noted, the demand for additions to plant and equipment in time of war is even more inoperative than in times of peace.

E. *Utility rates have been declining while other commodity prices have been rising.*—The utilities alone have been unable to increase the selling price of their service to offset higher tax and operating expenses. Obviously they are more limited in realizing excess profits than unregulated industrial corporations. Table 1, following, shows that prior to the order of the Office of Price Administration freezing prices at the levels of March 1942, prices in other than the utility field had increased substantially above the levels of August 1939. To offset rising costs, where prices were frozen or at ceilings, the Office of Price Administration proposed Government subsidies. The utility industry has experienced rising costs and has actually lowered its rates, gets no subsidy and seeks none, and is nevertheless being subjected to a type of taxation designed for a free-price and unregulated industry.

TABLE I.—*Price of electricity declined compared to other prices as of March 1942*

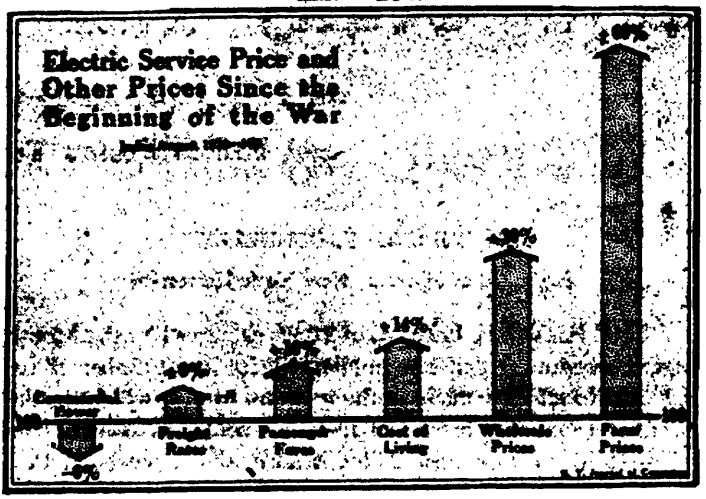
[August 1939=100 percent]

March 1942 price of electricity	
Industrial	90
Residential	97
Commercial	95
Other prices:	
Railroad (passenger)	106
Railroad (freight)	110
Cost of living	114
Wholesale	130
28 basic commodities	166
Prices received by farmers	166

CHART I

Electric Power Rates Lag

MARCH 1942

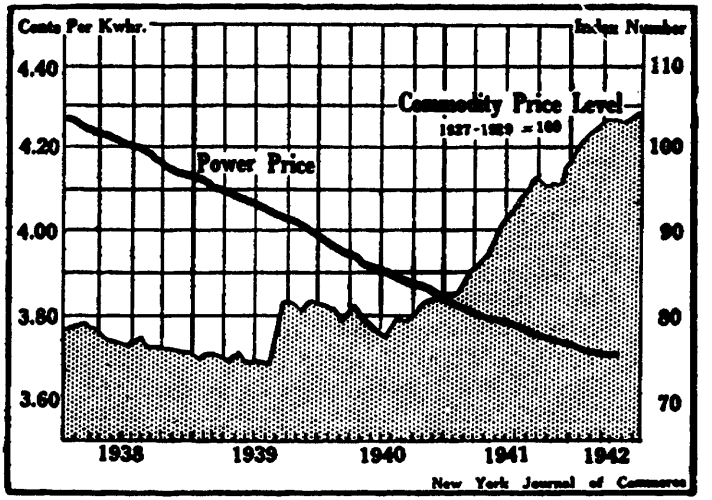


ELECTRIC power rates are now lower than at the start of the war, while other services, such as railroad freight rates and passenger fares, are substantially higher. The difference in trend is particularly marked in comparison with commodity price and cost of living indices.

NEW YORK JOURNAL OF COMMERCE

CHART II

Decline in Power Rates Continues



DESPITE wartime influences on the general commodity price level and a continued rise in utility operating expenses, such as taxes, labor and materials costs, the uninterrupted decline in electric power rates has not been broken to date. This record would be threatened seriously under the Revenue bill passed by the House.

NEW YORK JOURNAL OF COMMERCE

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F. *Yet, utility taxes have increased markedly.*—The utility industry is not exempt from taxes on industrial corporations such as corporation franchise tax, property tax, sales tax, and other similar levies. However, utilities are subject to a series of taxes from which industrial corporations are exempt, such as tax on gross receipts, franchise tax, license tax, tax on production of electricity or distribution of natural gas, and other miscellaneous taxes unique to utilities. Of the 48 States, 41 impose 1 or more of these specific taxes on utilities. Some have a special tax on utility property. Some States tax intrastate utilities on their property and interstate utilities on gross earnings. In addition, even the Federal Government has specific and unique taxes on utilities net earnings. It discriminates against them, and therefore is under some obligation to give them relief from taxes on corporations not so specifically selected for taxing when such general taxes prove destructive or threaten destruction. The rise in such specific taxes in the last 7 years is shown herewith.

Specific utility taxes

[All figures in millions of dollars]

	State utility property taxes	Other State utility taxes	Total State utility taxes	Federal taxes		Total special utility taxes
				Electrical energy	Transportation and transmission	
1935	$45	$49	$94	$33	$29	$156
1941	39	102	145	47	40	232

For the utility industry as a whole the percent of gross revenue spent for taxes has doubled in the past decade.

Growth of electric-utility-tax burden

[Percent of gross revenue]

	Spent for operating, maintenance, and depreciation	Spent for taxes	Balance available for return on investment and expansion
Year:			
1930	46	10	44
1935	43	14	43
1940	49	18	33
1941	50	20	30

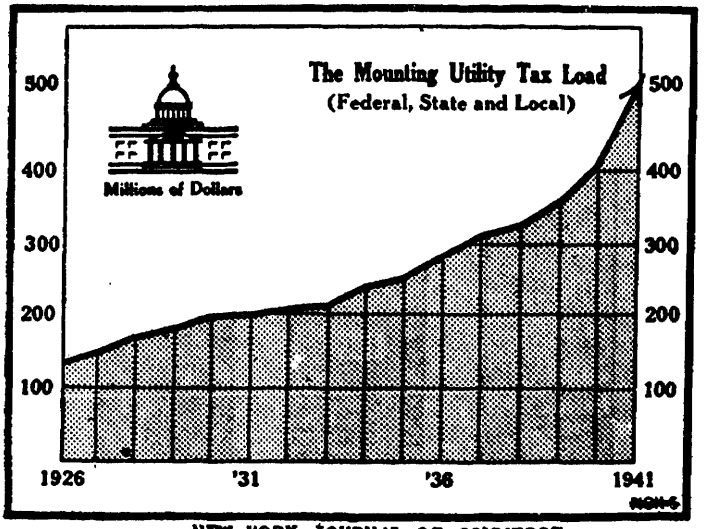
G. *Utility statistics show long trend of falling rates and rising taxes.*—Taxes rose in dollars faster than the gross income.

Edison Electric Institute data—private industry only

Year	Plant capacity (kilowatts)	Relative figure	Plant output (kilowatt-hours)	Relative figure	Average domestic rate (cents per kilowatt-hour)	Relative figure	Total taxes	Relative figure	Percent tax to gross
1926	21, 819, 000	100	65, 480, 000, 000	100	7.00	100	$133, 000, 000	100	9.4
1941	35, 994, 000	165	114, 205, 000, 000	220	3.73	53	511, 000, 000	380	20.6

During these 15 years the utility industry was chiefly a tax-collecting agency. At the same time it reduced its rates. Despite many obstacles, the industry increased its generating capacity and is making an important contribution to war production.

CHART III

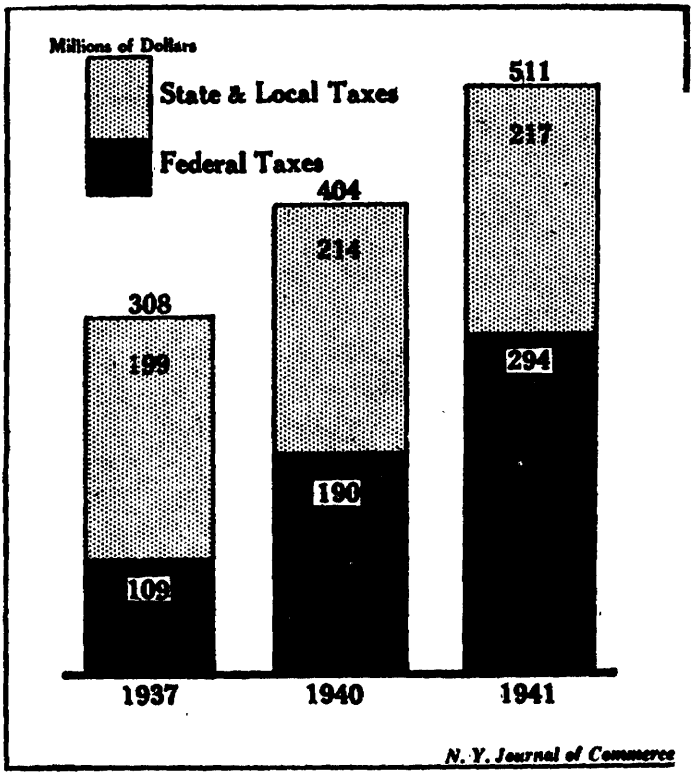


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CHART IV

The Erosion of Utility Earnings



THE INCREASE in the utility tax burden in recent years has been due almos entirely to the trebling in Federal taxation since 1937. The above breakdow for 1940 and 1941 is based on Edison Electric Institute estimates for abou 70 per cent of industry. The 1937 totals are census figures.

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H. Utility costs have risen but utility selling prices have fallen.—

Item	1939 index	1942 index	Item	1939 index	1942 index
Taxes	100	145	Equipment and construction—Con.		
Labor	100	108	Cable	100	127
Fuel: Oil	100	107	Transformers	100	110
Equipment and construction	100	112	Electricity prices:		
Poles	100	124	Residential	100	98
Conductors	100	116	Commercial	100	97
			Industrial	100	99

Recent monthly figures show the trend strikingly.

Wholesale selling prices and items in cost of production

Item	August 1939	March 1942	May 1942	July 1942
Electricity rates	100	86	84	(1)
Fuel oil, Pennsylvania grade	100	129	135	138
Bituminous coal, average of grades	100	113	113	114

[1] Not available.

Source: Wholesale Price Division, U. S. Bureau of Labor Statistics.

I. Utility net earnings have been declining, 1939–41, while industrial net earnings have been rising.—For unregulated industries, price rises and sharp increases in volume have resulted in a substantial increase in annual income, but for the utility industry the net income before interest and dividend is decreasing with declining rates and rising costs and rising taxes.

TABLE II.—*1941 net income after all charges and taxes of electric utility industry compared with other industries*

[1939=100 percent]

1941 income of electric utilities	97
Food, tobacco	109
Industrial chemicals	111
Nonferrous metals	129
Oil	184
Iron and steel	223

The above table, based on the Federal Reserve bank monthly bulletin of July 1942, shows that net utility income after taxes has declined in 1941 from the 1939 level, whereas other industries have shown increases up to very substantial amounts. Here is a realistic presentation showing the need for a sound and fair tax program which recognizes the economic difference between the utilities and the other industries. Yet the Treasury collected "excess" profits from the utility companies. The ultimate result is confiscation, failure of vital services, and ruin of a fine source of taxes.

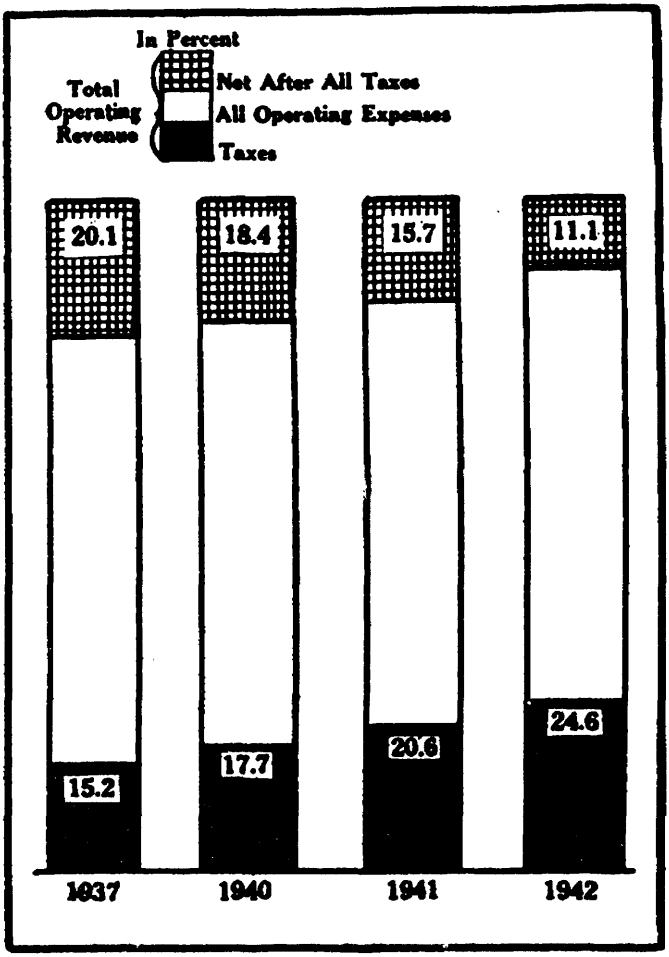
The following is an analysis of representative utilities having about 50 percent of the private utilities gross revenues, prepared by Lionel D. Edie & Co., based on a continuing study of a group of companies which had been previously selected by them for use for general statistical purposes:

	Net income, including taxes		Federal income and excess profits tax		Net income less taxes	
	Amount	Relative figure (percent)	Amount	Relative figure (percent)	Amount	Relative figure (percent)
1936	$212,802,000	100	$32,117,000	100	$185,685,000	100
1942 (estimated)	302,000,000	142	[1] 180,000,000	565	122,000,000	66

[1] $31,500,000 excess-profits tax; $148,500,000 normal and surtax.

CHART V

How Taxes Eat into the Profit Margin

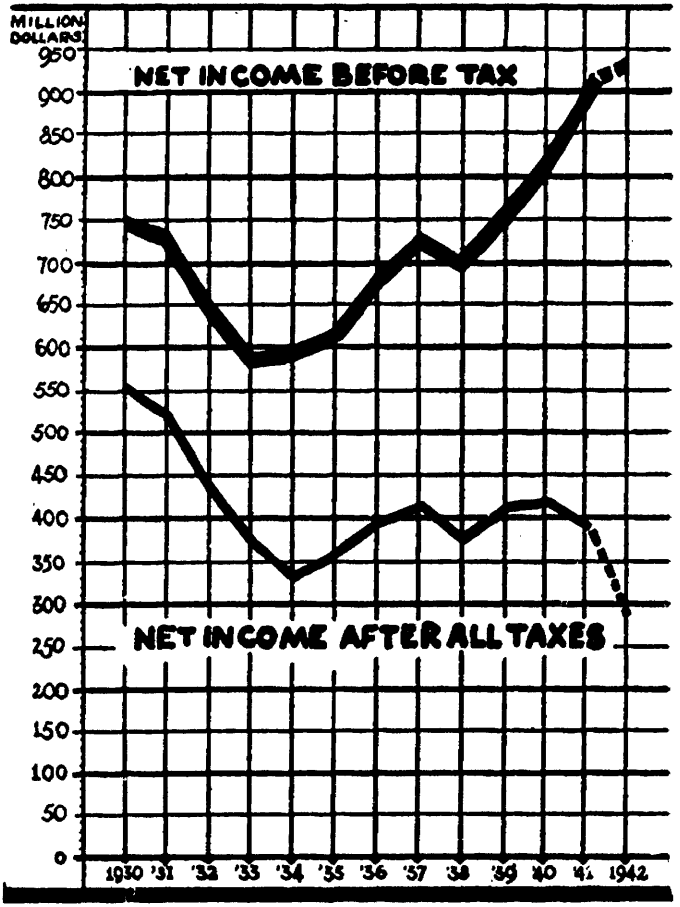


TAXES will take almost 25 per cent of total operating revenue of electric utilities in 1942, according to preliminary estimates. As a result, net income after taxes is expected to be a mere 11 per cent of gross revenues.

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CHART VI

Chart X: Net Income Related to Taxes



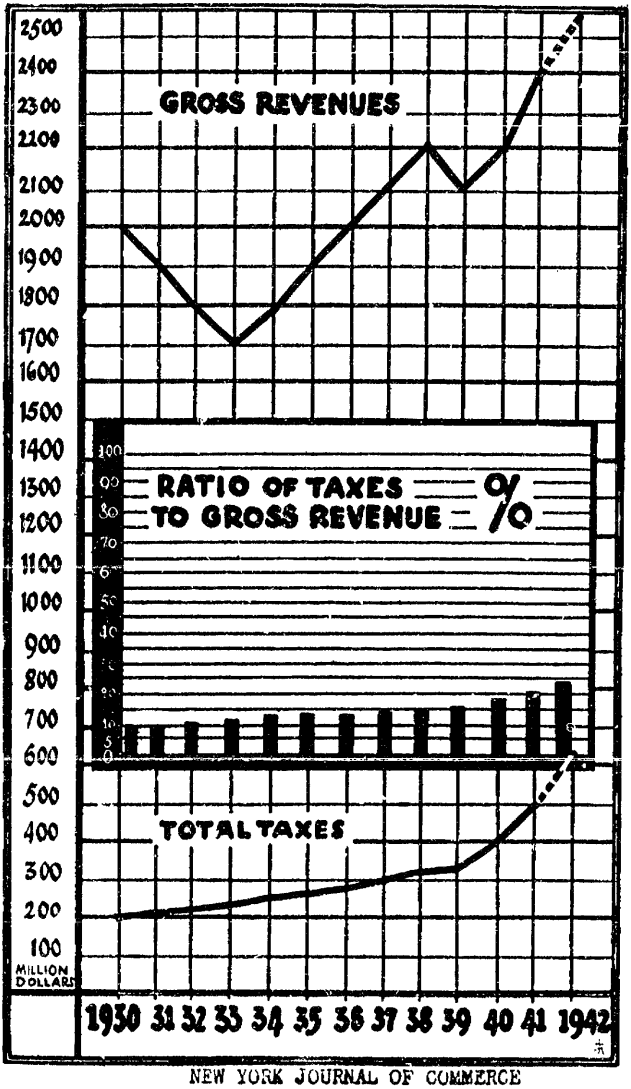
NOTE: All charts in this article are based on aggregate figures on companies making up over 75 per cent of industry.

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CHART VII

Gross Revenues Related to Taxes



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CHART VIII

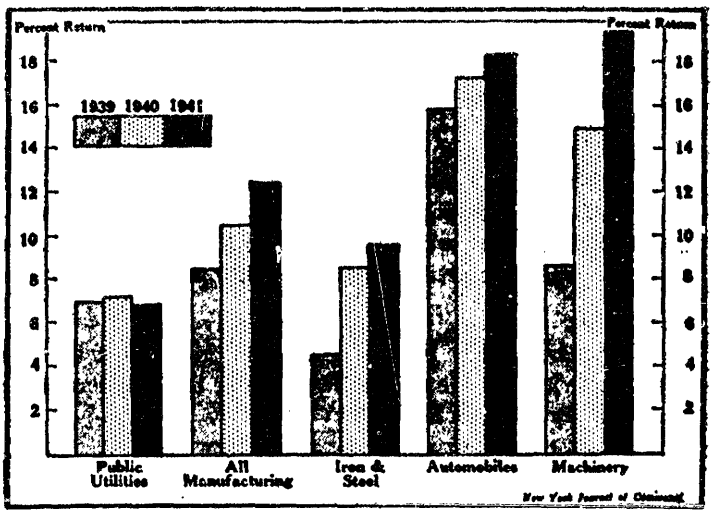
Return on Property Book Value



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CHART IX

Utilities' Return on Net Worth Low



WHILE the net income of the great majority of manufacturing enterprises has increased during the past few years, public utilities, as a group, have failed to maintain their 1939 earnings level. The chart shows the divergent trend in the rates of return realized on net worth of several groups of enterprises, as compiled and published by The National City Bank of New York.

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The burden of Federal taxes on utility companies is strikingly revealed in the recent reports of two companies, one privately owned and the other publicly owned, during the first 5 months of 1942 compared with 1941. The privately owned Virginia Electric & Power Co. reported an increase in gross earnings of 20 percent, but its net income declined 35 percent because Federal taxes were 85 percent higher.

Contrast this with the earnings of the publicly owned Seattle Municipal Light & Power System. During the comparable 5 months' period its gross earnings increased 26 percent, and its net income increased by more than 400 percent because it paid not one cent in Federal income taxes.

Why should the Federal taxpayers in the low-income brackets living outside of Seattle subsidize the rich consumers of electricity living in Seattle?

J. *Taxes discriminate against privately owned utilities.*—The publicly owned utilities are free of taxes on income, excise, and on property. Their customers are thus not bearing their share of the war obligations. Of course, if utility taxes were passed on to the consumer even the publicly owned utilities would make it possible for the consumers to bear their fair share of the war costs.

III. WHAT ARE THE CONSEQUENCES OF THE FEDERAL TAXATION ON UTILITIES?

Some industries, like utilities, sell their services at prices controlled by Government. They had price control long before the Office of Price Administration and Mr. Henderson appeared on the scene. Their return is limited by court decisions to 6 or 7 percent. The proposed normal and surtax totaling 45 percent, as against 15 percent in 1935, will cut this legal percentage drastically to levels far less than the court allowed and far less than is needed to attract private capital. Their excess profits above pre-war years are insignificant, especially in view of huge additional investment on which they are entitled to a fair return. In fact, they must contend with rising costs of material and with fixed selling prices. Profits are squeezed. Stocks become unattractive. As a result, such companies are compelled to finance by means of bonds. The Government thus encourages the development of a top-heavy capital structure while the Securities and Exchange Commission and the administration are urging reduction of private debts.

A. *The utilities uniquely have been hurt by the war and not benefited.*—Increased sales of gas and electricity, because of the war effort, are occurring almost entirely in the lower priced or wholesale services supplied to war industries. Coupled with this is reduction in sales to nonwar industries; reduction in home uses, due to dim-outs, official curtailment of appliance sales, ban on sales of gas for house heating, and decline in commercial use in nonwar fields. Thus, large increases in demand for service in kilowatt-hours or cubic feet of gas, necessitating expansion of plant and equipment, do not reflect themselves in corresponding increases in gross earnings.

The corporation tax works in reverse. The utilities have relatively stable income, industrials have sharply rising income; therefore, the burden is heavy on utilities and light on industrials. Utilities, unlike industrials, may be unable to meet dividends, or even investment requirements. The tax is discriminatory.

What other industry is thus affected? What other industry is subject to governmental regulation of selling prices in peacetime? What other industry serving so important a war purpose shows such a small increase in gross earnings? In what other industry is the ability to raise capital for expansion so impaired by heedless taxes? What other industry is pushed into Government ownership by excessive taxes? Is not this policy of the Government similar to the methods used by the financial pirates of the 1890's who would cut a dividend to depress the stock and then buy up stock sold in distress and then resume dividends, or who used to cause default interest, cheat the bondholders, get control of the property, and run it for the selfish interest of insiders? When the Government by taxation forces a utility into Government ownership, are not the methods similar? That the Government resorts to such practices, makes them no less unethical.

B. *Utility earnings are less than reasonable return allowed them.*—Rarely do companies earn the maximum allowed by the authorities necessary to keep in sound condition and to attract capital for expansion. Since the tax bill allows a limitation of 5 percent on capital in excess of $200,000,000, and then imposes a 45 percent corporation tax, there is really left only 2.75 percent. This is not a reasonable return. It will not attract additional capital. The utility companies would be glad in wartime to give up all the actual excess income above the base years, allowing for investments to serve war needs, plus a return on

expanded plant, but it is ruinous to expect them to have their return curtailed to substantially less than the base years allowed to industrial companies. How can such companies continue to function when the charge on their preferred dividends ranges from 5 to 7 percent?

C. *The percentage of taxation to net earnings has been rising.*—For example, nine companies in Ohio serving about 85 percent of the population showed, for 1941, in comparison with the 1936-39 average, a decline of 15.7 percent of net income under the rates in effect in May 1942, and would show a decline of 50.5 percent if the Treasury proposals had been in effect in 1941. Their average rate of return, of course, was less than 5 percent on the investment. The utilities are not being taxed for their war profits. They are being deprived of their pre-war earnings allowed as a maximum by the courts, rarely realized in fact, while doing a maximum war job.

D. *Proposed new taxes would further reduce earnings and dividends.*—The effect of the provisions of the House bill on a few operating companies is shown herewith.

Utility common-stock earnings

	Actual 1941 earnings	1941 earnings recalculated under the 45-90 percent of House bill	Percent decline from 1941 actual earnings	Actual 1936-39 earnings after them prevailing taxes	Percent decline of 1941 earnings recalculated under House bill from actual 1936-39 earnings
Consolidated Edison of New York	$2.09	$1.40	−30	$2.10	−33
Consolidated Gas of Baltimore	4.64	3.06	−34	4.47	−32
Detroit Edison	1.96	1.36	−30	1.50	−9
Niagara Hudson	.66	.47	−29	.67	−30
Pacific Gas & Electric	2.31	1.42	−38	2.60	−45
Public Service of New Jersey	2.04	1.25	−39	2.65	−53
Southern California Edison	2.38	1.60	−33	2.28	−30

The above calculations have been prepared from company reports by the Value Line Investment Survey of New York.

A table of earnings under the new tax proposals would show an excess profits rate not of 75 percent as in Canada, or 80 percent as in England, but of 200, 500, or even 1,000 percent. The effect of the proposed rates on typical companies follows: The Cincinnati Gas & Electric Co. would show under the present Federal tax laws a net income of 23 percent below the base period. Under the rates proposed by the Treasury the net income in 1941 would have been 68 percent below. For the Public Service Corporation of New Jersey the Federal income tax in 1939 took about 23 percent of the net income, and under the Treasury proposals about 75 percent, or if local taxes are included, 84 percent. In 1941 the company earned $2.04 per share, and paid $1.05 in dividends. If the Treasury-recommended proposals are adopted there would be little or nothing left for the common stockholders. The increase in Federal taxes for 1941 over 1940 for the Consolidated Edison Co. of New York was about $4,800,000, which was paid out of a decrease of $4,600,000 in annual dividends. In other words, the stockholder paid 100 percent tax on part of the dividends regardless of how small his holdings. For the industry as a whole, it was estimated that the House bill 7378 would cause a decline in net income of 30 percent below 1941. It is destroying taxpayers at a time when the Nation never needed them more greatly.

What are the effects on dividends? Dividends must be cut. There will then be less left in the hands of the individual for the Government to tax. And here it is important to distinguish between the American and British procedure. The British normal tax on income, available dividends is levied once only, at the source, or on the corporation. The British do not levy the normal tax a second time when the dividend is paid to the stockholder. We tax the earnings twice.

Was it not Chief Justice Marshall who said: "The power to tax is the power to destroy"? Up to the Treasury proposals of March 3, 1942, this was a forceful phrase. Now it threatens to become an actuality.

E. *The corporation tax is regressive.*—A tax of 45 percent on the earnings of a corporation is virtually a 100 percent tax upon the smallest investor on that part of the potential dividend which he does not get. Similarly, a reduction of dividend constitutes a 100 percent tax on the earnings withheld from the stockholder. With a corporation tax of 45 percent and excess-profits tax of 90 percent our rates

on individual income is much more burdensome to the stockholder than even the severe British rates. For the top brackets there would be a little difference. But our small stockholder is most unjustly and ruthlessly taxed.

When as a result of greatly reduced earnings, these companies cut their dividends, it will hurt not the large stockholders. Their net income after taxes would be cut anyway almost as greatly under the proposed steeply graduated individual income taxes. The House bill will hurt more severely the little fellow in the lower brackets. For example, if as a result of the Treasury proposals the American Telephone must cut its dividend from $9 to $6, this would be equivalent to a 33 percent tax on stockholders, or 100 percent on the first 33 percent of potential dividend. This would be regressive taxation. The approximate classification of the 634,150 stockholders of the American Telephone Co. at the end of 1941 was as follows:

Average number of shares held	Number of stockholders	Percent of total
1 to 10	343,000	54.0
11 to 25	145,100	23.0
26 to 99	110,500	17.4
100 to 999	34,700	5.5
1,000 or more	850	.1
Total	634,150	100.0

Under the proposed individual income tax a 33 percent rate on the entire income applies at about $20,000 probably exceeding the income of holders of 25 shares of telephone stock. Is it fair that 79 percent of the stockholders holding less than 25 shares should be taxed, through the corporation, at a rate so much above the level of rates set by the income tax, if the tax on dividends were paid by the stockholder? For these people, mostly small stockholders, the "prior tax" of 33 percent deducted at the source before their dividend is paid is a very heavy tax exceeding greatly their normal tax and surtax, which is payable in addition. Similarly, in the Consolidated Edison Co. of New York, of the 104,000 stockholders (common) over 30,000 owned 10 shares or less, and 55,000 owned 25 shares or less.

A large corporation has many small stockholders. In fact, the small privately owned corporation probably has stockholders with a higher average income than the lower 75 percent of the stockholders of the larger listed corporations. It is the stockholders, and not the corporation, that should be taxed on the ability to pay. Therefore, the proposed discrimination in favor of small corporations seems unsound and unrealistic.

According to the Temporary National Economic Committee, (Monograph No. 29, p. 10) there were between 8 and 9 million corporate stockholders in the country. Over 90 percent of these representing say 16 to 24 million voters, had less than $5,000 of dividend income in 1937. It is these whose earnings will be cut by 33 percent, 50 percent or more, through the Treasury proposals to tax the corporation 45 percent for the normal and surtax rates.

Every university, hospital, and charitable foundation owning stock will suffer. These tax-exempt institutions become taxable through the corporation. It is the sick poor in the privately endowed hospitals and the free poor students of privately endowed colleges who will have to bear the burden of the House bill's provisions for taxing corporations. The low incomes now lightly taxed become heavily taxed as the law did not intend. The House bill's provision for corporation taxation constitutes regressive taxation on the stockholders. Is this the intention of the House? If it is not, should not the error be corrected in the Senate?

F. *The tax discriminates against the big company.*—The graduated scale of permitted earnings on invested capital is clearly discriminatory. The graduation in favor of the small company has no basis in economics or logic. The large corporation is of as great use to the community and is bearing the brunt of war production and may have smaller stockholders.

G. *The rise in the rate of corporation taxes has caused switching back to the partnership firm.*—This is possible in small business but it is not possible in a large corporation. However the evil effect of the tax is reviving this tendency even though only the small-size companies can respond to the pressure. It is a symptom of the destructive forces threatening our corporate structure, which is essential in war production, in war taxation, and in post-war employment.

H. *The corporation tax favors debt against stock, unsoundly financed companies against soundly financed.*—Earnings available for bond interest are taxed once only, in the hands of the holder. Earnings available for preferred and common-stock dividends are taxed twice—once through the stockholders and once before through the corporation which pays its normal tax and surtax. The Government policy in the past 10 years has been to urge reducing debt of corporations and individuals, to replace bonds with stock.

Ignoring such policy of the other departments, the tax authorities now proceed to punish those who conformed to the Government's wishes.

To pay interest on a 3-percent coupon the company needs to earn but 3 percent, but to earn a 4-percent dividend the company must earn several times as much before taxes. By making stocks less desirable and stock financing more difficult, the tax policy will tend to force financing by means of bonds, leaving a weaker capitalization to weather the post-war period. The makings of bankruptcies lies in the hands of the tax committees of Congress. At the same time the Securities and Exchange Commission is pressing for immediate quasi-reorganization of completely solvent companies for the main purpose of reducing their debt securities. The result of such procedure will be not to make the company stronger but to increase its tax burden and perhaps lead to its destruction as a taxpaying private enterprise.

I. *The proposed taxes will prevent expansion.*—New facilities to meet the war demands can best be financed through common and preferred stocks. However, if laws penalize corporations for issuing stock or if the corporation follows a prudent financial policy, it will find itself in a quandary.

Public issue of preferred stock would become difficult for most utility corporations. As shown in the table submitted by W. C. Langley to the House committee, 20 percent of the dividends would have to be passed and 45 percent would be threatened. As for common stocks, a public issue, rare enough in the recent past, will become impossible. Not only would the earnings under the House bill prevent it, but in isolated cases, in which common stock issues would still be possible under the House bill, issues could not be made because of the fear of even less wise taxation in the future.

J. *Bond financing becomes difficult.*—When the House bill redefines "excess profits" as all above 5 percent and then takes 90 percent of the excess, the margin of safety for interest charges is thereby curtailed. Thus, the borrowing capacity of the utilities is reduced. Refunding to save interest is checked. New capital can be raised only with difficulty.

Before the tax rates on utilities in the House bill were put into effect, and at a time when it was inconceivable that such rates would be put into effect, contracts were made with bondholders providing for sinking funds, or repayment on installments. Such payments are either threatened or are now impossible.

This tax policy flies directly in the face of the policy of another Government department. The Securities and Exchange Commission in attempting to carry out section 7 of the Public Utility Holding Company Act has attempted to reduce debt as a percentage of total capitalization. The Commission stated: "* * * an adequate proportion of equity financing is appropriate both for reducing excess debt and for raising new capital, whenever and to the extent that the security markets permit."

Under the House bill this policy of the Securities and Exchange Commission cannot be carried out.

When the utility companies can issue preferred or common stocks easily they can then issue bonds at very low rates. This is of substantial benefit to the consumer because the plant investment in the utility industry is about eight times the annual sales. When a tax policy makes it difficult and impossible to sell stock, higher rates of interest must be paid on bonds. The long-term trend toward rate reduction to consumers is thus retarded.

The Securities and Exchange Commission sets strict standards for bond financing under the Public Utility Holding Company Act of 1935. Many operating utilities cannot now meet these standards. The proposed tax schedules will compel some companies to finance and prevent them from doing so.

K. *The tax program is a threat to the war effort.*—The utility companies are supplying power and light to the war industries. Should these companies become weakened it might hamper the production program.

L. *Utility companies will be weakened.*—(1) The corporation itself is adversely affected. The Government, by overtaxing, impairs the equity base underlying the bonds. As a result of the tax proposals, not only are common stocks reduced in earnings but the margin for the senior securities shrinks. Preferred stocks

and bonds have less in market value of junior money behind them. What will happen to the senior securities, owned by insurance companies? Is there no way of raising an equivalent amount of revenue without weakening the economic structure of the utility corporation? Besides, by taxing the corporation the Government is inconsistent. In other cases it has held that the corporation is a "legal fiction." Therefore, in antitrust suits the Government seeks to fine and punish officers and directors. It also breaks up personal-holding corporations to get at the real owners. But in taxation the Government says that the corporation is not a fiction but a real person and should be taxed in addition to the stockholders who are the real owners of the corporation. The British Treasury, by contrast, taxes the stockholders very heavily but virtually ignores the corporations' base-year incomes except for undistributed profits, and it levies an excess-profits tax, designed to keep dividends from increasing.

(2) Furthermore, even corporate margins and reserves would in some cases be reduced or wiped out. Difficult times are ahead of us after the war. Corporations will need reserves for adjustment during the period of transition and of reconstruction. If commodity prices will fall, as they have after all wars, if unemployment will be extensive, where will the corporations find the margin of safety, or flexibility for readjustment to peace conditions?

In military strategy the worst blunder is to shoot one's own troops. In fiscal strategy this is equally true. The House bill is shooting at the source of its bond subscriptions, of its war taxes, and post-war revenues. This is not milking the cow but bleeding her to death.

(3) The liquid position of corporations will become impaired. With prices rising inventories cost more. Already the rise in prices and the increase in taxes in 1941 have left their mark on corporate balance sheets.

According to National City Bank Bulletin, March 1942, the composite balance sheets for 110 corporations at the end of 1940 and 1941 show a decline in cash of $133,000,000. Current liabilities, chiefly reserves for taxes, rose sharply. The ratio of current assets to current liabilities declined from 3.40 to 2.49.

Obviously, owing to rising prices the corporations are in a less favorable position with respect to cash and with respect to liabilities. Therefore, corporations which will be stripped of cash by the drastic tax proposal will have to turn to banks. Interest rates may rise. Government bond prices may fall. On a $100,000,000,000 debt a 5-percent decline in bond prices is $5,000,000,000, enough to offset the total revenue anticipated from this tax. The revenue anticipated may not be actually collected.

The Secretary of the Treasury said, "A tax which dips too deeply into the income of low-earning corporations may seriously affect their debt-paying capacity, if not their very existence." That is precisely what is happening. Utility companies are a low-earning group. Unless some provision is made which recognizes their unique character many will find themselves in difficulty and be a current confirmation of the aphorism of Chief Justice Marshall. "The power to tax is the power to destroy."

M. The tax proposals will force a trend of public ownership, which will facilitate tax avoidance by utility consumers.—The proposed tax rates will reduce the cash available for expansion. It will also reduce the dividends on stocks. How will they be able to finance? What other way out will there be other than Government ownership? Then such utilities would pay no taxes to the Federal Government, and the rest of the community would have to take over the burden. The high brackets of income can be taxed no higher. The low incomes will have to shoulder the burden. As Federal tax rates rise it becomes more attractive for a local community to take over privately owned utilities. The Treasury is the chief loser.

In 1941 the utilities paid as follows:

Federal taxes	$294,000,000
State and local taxes	217,000,000
Total taxes	511,000,000

Of the total gross revenues or collections from customers, taxes took over 20 percent. In other words, municipally owned properties can cut rates 20 percent and still compete with privately owned utilities, on the basis of exemption from Federal taxes and assuming suspension of local taxes.

For example the privately owned subways were recently taken over by New York City. In 1939 these paid over $10,000,000 in taxes. But the mayor, on August 3, 1942, comes before the Senate Finance Committee and pleads for continued

exemption of city bonds from Federal taxation. He states that unless Congress demonstrated an understanding of wartime problems of local government, "the whole system may blow up."

As taxes on utilities rise, as borrowing capacity is impaired, the privately owned utility company must borrow from the Federal Government. Where is the end of this course? It is a typical case of fiscal "rakes' progress." Does it not seem inconsistent for a municipal administration to cause default to the investor by refusing to raise subway fares, forcing the transportation system into bankruptcy, taking it over at bargain prices, losing tax revenue, and then going to the Federal Government and asking for tax exemption—in other words, asking the rest of the country to take over the local burdens? Such a chain of thinking makes Alice in Wonderland look like reality.

As extremely high taxes undermine utility credit, there will necessarily be a tendency for these companies to turn to Federal agencies for new capital. Should the utility industry become dependent to any large extent upon the Government for sources of capital, there will be one more argument for State and municipal, if not Federal, ownership of public utilities.

One of the important utility companies is trying to sell one of its isolated properties to a neighboring company. However, this private purchaser cannot bid as high a price as the municipality itself, which is exempt from Federal taxes and which, therefore, can capitalize this tax exemption and pay more.

Bankruptcy, by Government tax policy, of privately owned utilities, will result in Government-owned utilities. These pay no Federal income taxes. Their consumers are thus subsidized by the rest of the country. How long can we shrink the number of tax-paying utilities? How far can we reduce the sources of taxation? How long can we permit such legalized dodging of Federal taxes? How long can we subsidize consumers well able to pay? No wonder that public sentiment generally opposes the trend to Government ownership.

N. *The morale of the private investor will be shaken.*—As the tax bill began to assume shape the investment advisory services like Standard Statistics and Poor's and Moody warned their clients about the risk in utility senior securities and advised their sale.

(1) What are the effects on market values? The Treasury proposals were submitted to the Ways and Means Committee on March 3. In 1 month the New York stock market suffered a decline in market value of over $2,000,000,000. The price movements were paradoxical. The best stocks broke pretty badly. Speculative bonds actually rose to new highs for several years. Striking examples are numerous. Whole groups of industries, whose earnings either were not materially increased or actually decreased by the war actually would have to bear higher taxes. This is particularly true of utility companies.

To show the unique, specific and discriminatory character of the tax on utility companies, one needs but to compare the effect on market values. Let us examine the record of market prices from July 1, 1941 to July 1, 1942, the period when there issued from Washington suggestions for taxing away all earnings over 6 percent, and actual tax proposals by the Secretary of the Treasury for drastic increases in taxes on corporation income and excess profits.

Total market value of groups of securities listed on the New York Stock Exchange

[All figures in million dollars]

	Common stocks		Preferred stocks	
	Amount	Percent	Amount	Percent
Group I. All operating public utilities:				
July 1, 1941	$4,845	.....	$1,493	.....
Mar. 1, 1942	3,903	.....	1,292	.....
July 1, 1942	3,460	.....	1,170	.....
Loss, July 1, 1941, to July 1, 1942	1,385	28	323	22
Loss, Mar. 1, 1942, to July 1, 1942	446	11	122	9
Group II. Industrials:				
July 1, 1941	25,369	.....	3,977	.....
Mar. 1, 1942	22,603	.....	3,850	.....
July 1, 1942	21,874	.....	3,709	.....
Loss, July 1, 1941, to July 1, 1942	3,765	15	263	7
Loss, Mar. 1, 1942, to July 1, 1942	729	3	141	4

What does this table show? From July 1, 1941, to July 1, 1942, utility common stocks shrank in value 28 percent and industrial common stocks 15 percent. The statement of the Secretary of the Treasury about confiscating the earnings of 6 percent came in September 1941. Worse, however, is the record since March 1, 1942. On March 3, the Secretary put out his tax proposal to tax corporations 55 percent for normal taxes and surtaxes and for a 75-percent tax on so-called excess profits and to reduce the allowable credit base for figuring excess earnings. From March 1, 1942, to July 1, 1942, utility common stocks declined 11 percent and industrial common stocks only 3 percent.

The shrinkage in the values of preferred stocks confirms the specific, unique, and discriminatory effect on utilities of the tax-policy provisions of the House bill. From July 1, 1941, to July 1, 1942, preferred stocks of utilities declined 23 percent, but industrial preferred stocks only 7 percent. From March 1, 1942, to July 1, 1942, utility preferred stocks declined 9 percent and industrial preferred stocks only 4 percent.

(2) The Treasury will lose money on inheritance taxes. According to the annual report of the Secretary of the Treasury for the fiscal year 1940, the gross estates of decedents for 1937 to 1939 ran between $2,800,000,000 and $3,100,000,000. The inheritance tax collected by the Treasury approximated $300,000,000. The projected Treasury program of increased corporation taxes, normal, surtax, and excess profits, has caused a decline in all portfolios. This decline may continue further if this proposal is not modified. Thus, estates of all decedents may shrink one-third or close to $1,000,000,000 and thus cause a loss of at least $100,000,000 in inheritance taxes.

(3) The decline in prices resulting from the proposals on corporation taxes has virtually caused a capital levy on the country but ironically without bringing receipts to the Treasury. The effect of the proposals for taxation was to cause such a decline in market values of all assets as might be equivalent to a capital levy of 33 percent. In the hope of getting a tax increase of $3,000,000,000, the Treasury's proposals already caused a decline in 1 month of over $2,000,000,000 in the market value of New York Stock Exchange listed securities alone. However, there has also been a corresponding decline in all other income-producing property; that is, real estate, farms, out-of-town stock exchange securities, and over-the-counter securities totaling another $150,000,000,000 in value.

If the ratio of depreciation on New York Stock Exchange securities held similarly for all the above assets, then in 1 month the Treasury proposals caused a loss to the people of the United States of over $10,000,000,000 in market value. Interestingly enough, Great Britain with a burden of taxation far heavier than in the United States has followed a careful and rational system of taxing corporations. As a result, the London stock market today is higher than in September 1939, but the New York stock market is about 30 percent lower. Of course, the degree of inflation is also a factor. However, it should not be beyond the limits of sound policy to devise a system of taxation which will produce revenue without destroying values.

(4) What are the effects on United States Government bond subscriptions? When the Treasury strikes $10,000,000,000 from the market value of the assets of the people of the United States, is it not bound to have repercussion on subscriptions to War bonds?

O. *House bill, H. R. 7378, will not check inflation.* It is unsound to think that all taxation is noninflationary and that all loans are inflationary. Inflation arises not from the mere issue of loans. Inflation arises from an increase in the prices of goods and services, of food and wages. House bill provisions for taxing corporations will not reduce consumption. They will reduce production. These proposals are not deflationary to commodity prices and to the general economy. They are deflationary only to stock prices. Thus they hide the real facts. They produce the illusion of deflation. To check inflation, the purchasing power of the population must be limited. This can be accomplished directly by rationing, by control of prices and wages, by a strong drive for savings, by a withholding tax, or by a sales tax reducing excess purchasing power.

P. *The Secretary's principles of taxation have not been put into practice in the House bill.*—The Secretary of the Treasury said on March 3: "A tax which absorbs

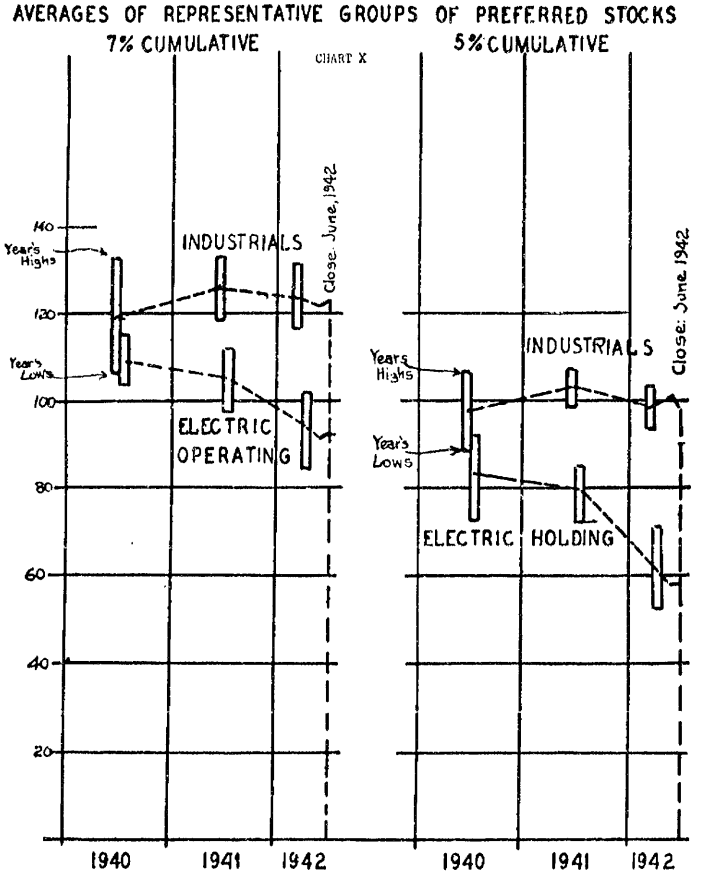
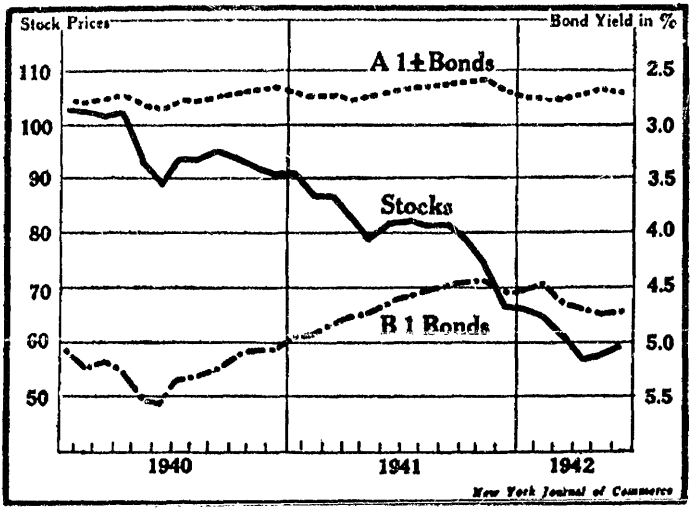

AVERAGES OF REPRESENTATIVE GROUPS OF PREFERRED STOCKS
7% CUMULATIVE
CHART X
5% CUMULATIVE
Close: June, 1942
Close: June, 1942
140
120
100
80
60
40
20
Year's Highs
Year's Lows
INDUSTRIALS
ELECTRIC OPERATING
Years Highs
Years Lows
INDUSTRIALS
ELECTRIC HOLDING
1940
1941
1942
1940
1941
1942

CHART XI

Impact of Taxes on Utility Stocks



THE MOUNTING burden of Federal taxation has cut deeply into utility earnings, compelling dividend cuts. This has been reflected in a continuing decline in equity prices while bond quotations have been unaffected. The above chart is based on the public utility bond and stock price averages compiled by Standard & Poor's Corporation.

excess profits still leaves the corporate taxpayer with a sufficient margin of income for dividends and safety." The bill passed by the House committee has not given effect to the principle enunciated. Utilities will have inadequate "margin of income for dividends and safety" but may even be unable to meet the sinking fund or installments on debts contracted to provide facilities for war production.

IV. WHAT ARE THE CAUSES?

A. *The theory of the tax is unsound.*—In Great Britain, as cited above, corporations pay a tax equivalent to the normal individual income tax of 50 percent, only because this tax is deducted at the source. Therefore, the stockholder does not pay the normal individual income tax a second time. He is, of course, a subject to supertaxes on individual income up to 47 percent or a total normal and surtax of 97½ percent.

The corporation itself is subject to a tax on genuine excess profits. In Great Britain this was originally 60 percent in 1939 and then raised to 100 percent in 1940. The 100-percent rate checked production and it therefore was reduced in 1941, by the promise of a refund of 20 percent at the end of the war. All excess profits above the earnings of base years are subject to excess-profits tax. The individual is not entitled to relief on account of excess profits paid by the corporation. The corporation itself pays no surtax. As a result, earnings of British corporations, even under a high excess-profits tax, do not fall below the pre-war base.

In Canada the base is the average profit of the years 1936-39. Above this base there is an excess-profits tax of 75 percent or a tax of 22 percent on the total profit, whichever is larger. However, like Great Britain and unlike the United States, Canada allows the corporation to deduct the income tax before figuring the excess-profits tax. In both England and Canada excess profits declined as price ceilings and control of consumption became effective. This result was expected. The tax along with a sales tax and a withholding tax was regarded not so much as a revenue producer as a check on price increases. In the United States we took no direct measures to control inflation as all over price ceilings, rationing, control of consumption, but threw the whole burden on the excess-profits tax. This is like running an auto, using the emergency brake all the time, but pressing the accelerator and feeding gas to the motor.

We followed one British practice on normal tax on dividends until 1936. We taxed the income once only, at the source. Unlike Great Britain, however, we taxed corporate incomes at a rate which bore no relation to the income of the stockholder. Then in 1936 we revised our income-tax law and taxed both the corporation and the stockholder on the same income. The principle of a graduated income tax on corporations in the Revenue Act of 1935 was reluctantly accepted in the majority report of the Ways and Means Committee. "The President recommended the substitution of a graduated income tax on corporations in lieu of the present income tax imposed at a uniform rate. This is a new principle which has never been used in this country and therefore your committee is recommending only a very moderate graduation" (then 1 percent). The House bill now proposes a 45-percent tax, thus revealing the error of compromising on a principle. According to the minority report the graduated tax on corporate incomes was criticized because "it failed to look beyond the corporate entity to the millions of stockholders, most of them of small means, who actually make up the larger corporations." The minority report of the Senate Finance Committee opposed the tax because (1) "it disregards the number of stockholders in the corporation and their relative abilities to contribute to the support of the Government, and (2) it discriminates against the small investor in the large corporation and in favor of the large investor in the small corporation." Then we added a tax on undistributed profits to make sure of the double taxation. The undistributed-profits tax was repealed. But the double taxation remains.

The error of taxing the same income twice, bad as it is in principle, had little serious effect when the rates on corporations and individuals were low. But when the corporation tax is raised to 45 percent, as in the House bill, the error produces a grave effect on the whole economy. If the Treasury proposals are carried out the wartime earnings of American corporations will fall substantially below the pre-war base and in many cases to one-half or less. The effects

of this sudden and drastic curtailment of earnings is to injure many aspects of the economic life of the country.

In what country of the world is the rate of tax on corporations so high? In what country in the world, except in Canada, is there a surtax on corporations? Perhaps they copied our bad example.

We could well afford to copy the Canadian precedent of taxation. They have a sales tax. The normal individual income-tax rates are higher. They deduct their taxes at the source. The supertax rate starts at a higher level. They have no capital-gains tax. They have compulsory saving in the form of percentage of the income tax but repayable after the war. They have a less confiscatory inheritance tax. They go to great length in giving special consideration of unique problems of particular industries, as lumbering. They give great latitude to the Department of Finance in easing hardships.

The very concept of a "surtax" on corporations is economically meaningless. The "surtax" should represent an added ability to pay, as in the individual income tax. Not corporation earnings, but stockholders' income represents ability to pay.

The corporate "surtax" applies to corporations with stockholdings of all sizes. It is not graduated upward for the sole owners of a moderate-sized corporation nor is it graduated down for the large number of very small stockholders who constitute 50 percent and more of the total number in the important corporations, as shown above. The tax has no basis in knowledge of economics or in tax theory. It is convenient to the tax collector but cruel to the unorganized small stockholders.

Earnings will be greatly reduced. W. C. Langley submitted some figures to the House Ways and Means Committee, volume 3, page 2694–2705, showing the effects of a 45-percent tax on corporate income and 75-percent-excess-profits tax. He presented the results in the case of 42 operating utilities having preferred stocks. Of these, 8 would not earn anything on preferred dividends, 17 would not earn anything for preferred dividends plus sinking funds, and 19 would earn less than 50 percent of their preferred dividends and be border-line cases. All told, the average covered of earnings for preferred dividends declined from 2.30 times to 1.44 times. As for their common stocks, of those which had anything left after the preferred, 13 companies would show earnings on the common reduced from 2.35 to 1.33 or about 44 percent.

Obviously, what the above record of earnings reveals is an excess-profits-tax rate not of 75 percent as in Canada or 80 percent as in England, but of 200 percent, 500 percent, and even 1,000 percent. The British and Canadians have imposed a very heavy tax but it was a rational tax, levied with an eye on its general economic effect.

B. *A corporation is really fiction as a taxpayer.*—It is the individual who is the real taxpayer. This is evident in the switching of small companies from the corporate form back to partnership. This is also evident in the Government's policy in the antitrust law where they go behind the corporation and seek out the directors and the officers to fine and punish. A corporation is engaged in production. Production should be encouraged, not checked. The individual is a consumer, and it is consumption which should be checked and not encouraged, and taxes now on the corporation should really be levied, as in England, on the individual.

C. *Utility company differs from the industrial company which has a great increase in volume, substantial rise in selling prices, and an increase in net.*—The utility industry for the 4 years 1936-39 showed an annual average revenue per kilowatt-hour of 2.20 as against 1.90 for 1941, and a decline in earnings. Herein lies the essential difference in applying the corporation tax to utilities as compared with industrials.

D. *The public utilities are already paying heavy taxes.*—For example, the Consolidated Edison Co. pays a public-utility excise, or local tax; a conduit company excise, or local tax; a public-utility gross income tax, a special State tax; and an electrical energy tax, a special Federal tax. The total in 1941 of these four taxes amounted to $12,800,000, or 20 percent of all the taxes. The case is typical of the industry. What other industry is subject to corresponding local, non-Federal taxation? The Federal tax on corporate incomes, though wrong in principle, was still tolerable when the rate was low. At about the 45 percent level it becomes not only intolerable, but threatens to be destructive. Its basic unsoundness is evident by its effect in the public-utility field which cannot absorb it. The tax may be collected but may seriously harm the industry. Who can tell which industry is next or which is safe from similar threats?

E. *The uniform system of accounts prescribed by the commissions allowed deduction of income taxes and other taxes from operating revenue.*—These classifications of accounts were prescribed at a time when income taxes were not so large a part of the total tax burden. As recently as 1937 the corporation tax was 15 percent as against the proposed tax on corporations, normal and surtax, of 45 percent, plus a 10 percent excess-profits tax. When the tax rates were low a rise in taxes could be passed on through a rise in rates. In fact, however, because of efficiency rates declined while taxes rose. Under the proposed 90-percent excess-profits tax, it is not possible to raise rates by nine times the costs of increased taxes.

V. WHY THE UTILITIES NEED RELIEF

A. *Utilities are vital to the prosecution of the war.*—Throughout the country they are serving the producers of steel, manufacturers of tanks and airplanes. The inability to meet adequately the wartime needs of the country would be a serious problem. Here is an overwhelming reason for careful reexamination of the tax status of the utility companies in the pending bill.

B. *The utilities must raise new money.*—Those that are close to war industries or to military camps have a priority and must expand their plant or investment. To raise funds required the company normally must sell their common and preferred stocks, or bonds. The proposed tax on utilities will prevent any but the strongest from doing so. Today, the utilities expand by cutting or passing dividends and by using funds reserved for renewal and retirement.

C. *Public utilities are vital in the transition period.*—After the war there will be a large army of unemployed. The utilities could make up deferred maintenance and for those which had not expanded during the war embark upon a program to meet anticipated needs. They could buy hundreds of millions of dollars of new machinery. To do so they must be in sound financial condition. If wartime taxes, levied indiscriminately and without regard for the unique character of the industry, strip the companies of cash and weaken their credit, the utilities will not be able to buy and thus to reemploy the men in the electrical equipment industry.

D. *The utility industry is vital to the country's economic life.*—One could write a history of the economic development of the United States in the terms of the utility industry. There is a close correlation between the kilowatt-hour per worker, the number employed in American industry, the national income, the productivity per man, and the standard of living. The report of the President's 1938 Committee on Labor Abroad showed that the number of days worked to provide the same minimum necessities to live was lowest in the United States. If this process is to continue, utility companies must be maintained financially sound and the Senate Finance Committee must review the tax proposals of the House.

E. *The Canadian Government has been successful in its tax policy.*—The Honorable C. Fraser Elliott, Commissioner of Taxation in Ottawa, cited a few principles of wartime taxation which we may well ponder: "That war taxes and their increasing weight should be contained as far as possible in the special war measures, and not in basic, continuing measures. * * * That between the industries favored by credits, and those restricted by design, there is a large, substantial, continuing middle group which was there before the war and will be there after the war, and on that group there should be a tax sufficiently heavy to recover to the taxing authority as much of the excess profits and excess spending power as possible, but leaving business always with a profit incentive, although diminishing in percentage, having regard to increasing power of turn-over * * * That a deadline for profits in the form of 100-percent tax in a capitalistic system is the frustration of its basic principles and the destroyer of hope, for without hope, even though hope take the form of an after-the-war partial refund, industry wanes * * *. That the intention to impose severe taxation should closely follow the rising national income but not so fast as to preclude opportunity for appropriate adjustment of private and corporate affairs. * * * That the stimulus to the national income occasioned by war should not be heavily taxed without at the same time giving special credits or allowances to those who incur substantial capital expenditures which will have little or no post-war value; and that these tax credits and allowances should be both selective as to those favored and circumscribed in their terms. * * * That all business concerns and the people of the Nation should be made to feel that there is a genuine bond of sympathy and understanding between the Government and them in relation to their numerous and difficult

problems and that multitudinous though the affairs of the Government are, they are not so complex but that the problems of each may receive substantially individual consideration."

VI. WHAT ARE THE POSSIBLE REMEDIES

A. *It should be possible to find a sound tax which is fair to the utilities.*—It should not discriminate against them. It should remove hardships resulting from applying a tax structure to the utility industry suitable for industrials. It should give utilities special relief which will meet this special situation.

In England and Canada there is latitude and discretion to take care of the specific problems of some industries or groups of taxpayers. Even in the United States there is a sound basis for the request by the utilities for fair and appropriate specific adjustment to avoid the unfair impact of general taxes. For example, the American railroads are authorized to buy in their own bonds at a discount without paying capital-gains tax thereon, thus enabling them to reduce their debt, which is the specific problem of the railroads. Again, in the case of the petroleum and other natural resources industries depletion allowances are properly permitted which are unique to such industries. Again, the railroads, who are not able to obtain adequate material for maintenance or expansion now, are permitted to set up special reserves for future maintenance, which is charged to the current account and provides cash in the post-war period, to give employment. Why should not the utility industry have similar specific recognition? Not as a favor, but as a right. The British Government is being petitioned by utilities, including municipal, to increase depreciation charges on account of added wear and tear in wartime.

B. *A rate increase is impracticable.*—For example, in Ohio the utility companies have rate contracts with individual communities, and would therefore have to renegotiate rates with each community. The state utility commission has no authority to make blanket increases, even in wartime. Again, even where the State commission has authority, rate increases require lengthy hearings, and consume much time. Meanwhile the companies are actually hurt.

Under the present tax structure of high excess-profits taxes and high tax on corporate income, the rate increases must be very large. When every increase in income is subject to excess-profits tax of 90 or 95 percent then the rates to the consumer must be raised 10 or 20 times the amount required to reimburse the utility company for the loss of income through taxes on corporate earnings. Such increases would not be tolerated by the consumer.

C. *Pseudo remedies, like subsidies, have been suggested.*—For example, in a recent request for increases of utility rates, the Office of Price Administration objected on the grounds that it would cause inflation by raising the cost of living of the consumer. Therefore the Office of Price Administration advocated subsidy rather than a price rise. Yet other industries were allowed to raise their selling prices as their costs rose. For the utility industry the remedy would not be a rate increase nor a subsidy, but a recognition of the unique character of the industry and the framing of a tax bill on such a basis.

D. *Some technical proposals applicable to other industries have been suggested.*—1. Deduct the corporation income tax before the excess-profits tax: Taxing excess profits before deducting the corporation's normal and surtax is unsound and unethical. The present deduction of excess profits before computing the normal tax is a recent innovation and we should return to the original form, for under the present provisions a corporation might be subject to excess-profits tax even if its net income, after deducting normal tax and surtax, was less than the earnings of the base period. This proposal has the support of practically every important witness for utility and other industries that appeared before the Ways and Means Committee.

2. The credit base for excess profits should be the Public Utility Commissioner's rate base: In the formula of the House bill "excess profits" are not real for they present not the profits over the base years but the profits over and above some artificial base selected by the Treasury. This base is substantially lower than last year. Why should not the rate base approved by the public-utility commissions for each company be substituted for the artificial base set up in the House bill hastily and without accurate knowledge?

3. Permit a credit against net income equal to preferred dividend in computing surtax: This will place a preferred stock on the same basis as bonds. The present sharp distinction between these two has no justification.

4. Permit a credit against net income for part of common dividends in computing surtax: Thus a corporation would be encouraged to pay dividends on which

the Treasury would collect individual surtaxes. The payment of common dividends makes expansion possible, through sale of common stock.

5. Permit a credit against net income for purposes of surtax and excess-profits tax of all payments for redemption of debt or to reduce debt, such as sinking fund or installments: This will put the companies in a strong post-war position.

6. Tax Government-owned utilities. The Federal revenue would be increased. Discrimination against private utilities would be eliminated and the consumers of the publicly owned utilities would no longer be subsidized out of public funds.

E. *The facts justify a straightforward demand for unique treatment for a unique industry.*—By treating the utilities uniformly with industrials the tax law discriminates against the utilities. Such discrimination must be removed.

The Secretary of the Treasury in his prepared statement to the House Ways and Means Committee on March 3, 1942, stated:

"With rates of this magnitude it is increasingly important to have a fair basis from which to measure the profits subject to the excess-profits tax. In addition to the many provisions in existing law to adjust earnings of the base period to take account of unusual circumstances, it is suggested that further relief be afforded where the earnings of the base period were abnormally depressed."

How apt this principle is for utilities. The utility industry is unique in several important respects. It has a very high investment per dollar of sales, and must raise large amounts of capital as demand for service increases. Its selling prices are regulated, and are not now allowed to rise with costs. It has publicly owned competitors which are comparatively tax-free. Taxes have been rising so rapidly that the rate of return is less than that allowed by the courts.

Such a unique industry as the utilities requires unique tax treatment. They should be allowed to earn the fair return as now approved by the utility commissions and the courts. The courts have declared as fair rates of 5 percent in some decisions and 6 and 7 percent in others. Hence, no tax should be levied that cuts the return to below the fair return. If necessary, for the war effort, all taxes above the legal fair return could be collected from the consumer.

To treat utilities and industrial corporations equally means discrimination against the utilities. A tax system should be made to order, not applied "ready-made." Unless it recognizes the specific problems of utilities the Government may find a whole sequence of problems on its hands after the war—all unnecessary problems which could be solved with a little insight and foresight. Unless an intelligent tax policy will be framed for the utilities the whole theory of utility regulation becomes utter nonsense. The opinions of the Supreme Court become just so much verbiage. The officials of the public-utility commissions become void of either authority or responsibility, acting not on their judgment, but like a jumping jack subject to any pull of the strings of Federal tax policy.

1. The utility corporations should not be taxable until they have earned a fair return as allowed by the courts: Such fair return is clearly net to the investor, for if it were the return before taxes the decision would have no significance, for any tax could reduce a 6 percent fair return to 3 percent, 2 percent, or even 1 percent. Until such legal return is earned they should be free of tax. After it is earned they should be subject to the same taxes as other companies whose earnings are not so limited.

Where the tax on the public utility finally should rest was decided by the Supreme Court:

"In calculating whether the 5-cent fare will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between State and Federal taxes, or between income taxes and others" (*Galveston Electric Co.* v. *Galveston*, 258 U. S. 388, 399 (1922)).

Public utility commissions which refused to consider the Federal 3-percent tax formerly in effect "as a part of the cost of service to be paid for by the consumers" were reversed by courts on the basis of the Galveston decision. Congress could carry out the intent of the Galveston decision by making it a general tax principle that public-service corporations should be allowed sufficient earnings to give a fair return on the investment as decided by several public-utility commissions. In other words, since the Government puts a ceiling over utility rates, should it not also put a floor under utility earnings? When the Government exercises certain rights with respect to the investor it automatically incurs certain obligations.

2. *When a commission limits the utility earnings to 6 percent on fair value that very fact means that excess earnings do not exist:* Rate reductions, to bring the return back to 6 percent, constitutes 100-percent tax on the excess earnings, or a confiscation of the excess earnings. The rate reduction and not the tax on excess profits accomplishes the purpose. Therefore the utilities justify a different tax treatment. Excess-profits tax should be equal to the amount by which earnings exceed the earnings in the base period, allowing for growth. This is another variation of the proposal that excess profits be levied only after the permitted return.

A Supreme Court opinion sets forth the principle of the investor's right to a fair return, which has been consistently flouted by the tax authorities:

"The thing devoted by the investor to the public use is * * * capital embarked in the enterprise. Upon capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return. Thus it sets the limit to the power of the State to regulate rates. * * * The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes, not only operating expenses, but also capital charges. Capital charges cover allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor, the allowance for risk incurred, and enough more to attract capital" (concurring opinion in *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 289 (1923), by Justice Brandeis).

3. Since the courts allow a legal rate of 6 percent on fair value if the Government insists on taxing the companies to reduce the return below this rate the tax should be passed on to the consumer as a special war excise per kilowatt-hour. This is a cheaper method, less burdensome to the consumer than the rate increase, of which the Government would take 90 percent.

This is not a new proposal. It is already in effect. More than 50 utilities have framed their rate schedules so as to permit the passing of certain taxes on to consumers. The methods vary. In some cases a percentage surcharge is added to the base bill. In other cases a percentage surcharge is added to the prescribed rates. Such additional charges would not be inflationary. Utility rates have not risen like other commodity prices. Utility rates have actually fallen. A surcharge would therefore merely go a small way toward bringing utility rates in line with other prices. If this surcharge is not levied on industrial users it will not raise prices. If it is levied only on residential users it would act as a deflationary force because the consumer would have less to spend on other goods.

If Congress does not provide for such transfer of the burden to the consumer what will be the result on the utilities? Investors, being expropriated, will avoid the industry. The cost of capital for the utility industry would rise. Rates to the consumer would therefore rise necessarily. In other words, the consumer must either pay a temporary surcharge during the war to help save the utilities and to avoid expropriating the investors or else he will pay permanently higher rates. The alternatives are clear.

There are precedents for such action by Congress. The House revenue bill actually provides a tax on freight and express charges, taxes on telephone and telegraph messages. Why cannot Congress carry this principle further and provide for similar charges on electric power service?

In summary, the utility industry asks for no favors. It asks merely for equalization of the tax burden on one industry, whose prices have been regulated downward, with other industries, whose prices are free.

To pass the burden of destructive taxation on the utility corporation to the utility consumer would merely equalize the price of electric service per kilowatt-hour with the prices which the consumer has been paying for other commodities.

There are decisions which uphold the right of utilities to pass the tax on to the consumer. Tax is a cost, the courts have held. The United States Supreme Court, in the case of *Georgia Railway & Power Co.* v. *Railroad Commission* (1922, 262 U. S. 625, 67 L. ed. 1144), tacitly upheld the doctrine that taxes may be passed on to the public or the consumer by holding that the Federal corporation income tax should be allowed as a proper operating charge or expense. There was no specific mention made of the fact that the result of that decision would be to pass the tax on to the public or the consumer.

There are many other cases which held in effect that Federal income taxes and excess-profits taxes are a proper charge to operating expenses and, therefore, ipso facto, these taxes are properly passed on to the public or to the consumer. That the Federal income tax imposed upon a public utility was a proper item of operating expenses was held in the case of *New York and Queens Gas Co.* v. *Prendergast*, 1924, 1 F. (2d) 351; *Monroe Gas Light & Fuel Co.* v. *Michigan Public Utilities Commission*, 1926, 11 F (2d) 319. A Texas court, in the case of *San Antonio Public Service Co.* v. *San Antonio*, P. U. R. 1924, (A) 259, held that income and excess-profits taxes imposed by Federal regulation should be included as an operating expense and treated as a part of the return. The other cases which hold that Federal income taxes are properly chargeable to operating expenses are: *People ex rel. Pennsylvania Gas Co.* v. *Public Service Commission*, 1925, 211 (A. D.) 253, 207 N. Y. Supp. 599; *Charleston* v. *Public Service Commission*, 1924, 95 W. Va. 91, 120 S. E. 398; *Re Chicago District Electric Generating Corporation*, 1941, 39 P. U. R. (N. S.) 263; *Re Andrew County Mutual Telephone Co.*, Case No. 9841, December 3, 1940, and *Re Hampton Water Works Co.*, 1940, 36 P. U. R. (N. S.) 404.

4. Reduce or abolish the corporation tax and increase the tax on dividends on a graduated basis. Utilities, already subject to an unusual tax burden, should at least be exempted from any further increases in the normal or surtax rate on corporate incomes, or else these taxes should be reduced for companies selling service at a price regulated by public authorities. Of course, we could follow the procedure of Belgium or Great Britain and instead of taxing the corporation, levy the tax on the dividend. The upper brackets would pay just as much and the lower brackets would get a square deal.

F. *The corporation tax and the excess-profits tax on public utilities may be unconstitutional.*—Supreme Court decisions granting the right of utilities to earn a reasonable return were rendered at various times. The return was allowed after taxes, which are considered an expense. If the Court allows, say, a 6-percent return, is it not inconsistent for Congress to levy a tax which will reduce that allowable return to 3 percent or less? Perhaps a tax which would thus reduce the return might be considered confiscatory and a violation of the fifth amendment to the Federal Constitution. Some authorities think it is.

1. It is to be pointed out that this opinion is open to qualification. Such qualification would include such factors as the political and economic condition of the United States at present, factors as World War No. 2, the value of money and the earning power of money, and the type of public utility involved. The above opinion, however, is based upon the following review of cases dealing with the question as to whether or not a certain rate of return is confiscatory.

A return of 7 percent was held not to be confiscatory in the case of *Pacific Gas & Electric Co.* v. *San Francisco* (1924), 215 U. S. 403, 68 L. ed. 1075. A return of 7 percent on value of property was held to be reasonable and not confiscatory in the case of *Wabash Valley Electric Co.* v. *Young* (1935), 287 U. S. 488, 77 L. ed. 447.

Village of Tupper Lake v. *Malthie* (1939), 170 Misc. 265, 10 N. Y. Supp. (2d) 53, held that a 5.8-percent return could not be considered confiscatory by a municipal electric utility. A 6-percent return was held to be reasonable and not confiscatory for a combined electric, water, and steam lighting utility. This is in the case of *Re Otter Tail Power Co.* (1940), 33 P. U. R. (N. S.) 301. A return of 6 percent was allowed on a rate base of a light and power company, *Re North Dakota Power & Light Co.* (1939), 31 P. U. R. (N. S.) 26. A return of 5 percent was allowed as reasonable for a telephone company, *Department of Public Service* v. *Pacific Telephone & Telegraph Co.* (1940), 37 P. U. R. (N. S.) 241, but a statute fixing a maximum rate for gas which would yield a return of less than 5 percent was held to be confiscatory in the case of *Ottinger* v. *Brooklyn Union Gas Co.* (1927), 272 U. S. 579, 71 L. ed. 421.

Rates under which a gas company produced a return of not more than 4.59 percent were declared to be confiscatory in the case of *Mobile Gas Co.* v. *Patterson* (1924), 293 F. 208. A statute which fixed a gas rate so that the return would be only 2.48 percent on the fair value was held to be confiscatory in the case of *Kings County Lighting Co.* v. *Prendergast* (1925), 7 F. (2d) 192. In the case of *Edison Light & Power Co.* v. *Driscoll* (1928), 25 F. Supp. 192, it was held that a return of 3.65 percent on the fair value of the property of a utility was confiscatory.

Cases show that in no case whatever have the courts gone so far as to hold that a 3.6 percent or a 4 percent return was not confiscatory. Therefore, in view

of the cases so cited, it is submitted that a present-day court, with a great deal of legal precedent behind it, may well be expected to hold that a corporate income tax of a very high rate would operate to reduce a utility's allowable return to 3 or 4 percent was confiscatory under the fifth amendment of the Federal Constitution as a deprivation or taking of property without due process.

2. Another important question involved is if the Supreme Court can overrule Congress, has Congress the right to overrule the Supreme Court?

3. Is it possible to limit the Federal tax on creatures of the several States whose rates are fixed like privately owned utilities which compete with publicly owned properties paying no Federal tax? These are rising steadily relative to the whole industry. Various proposals have been made. One is to set a limit to the total amount of Federal tax on companies subject to public regulation so that the income after taxes should not be less than the fair return on the investment. Again, Congress itself could provide in the tax law certain limits beyond which it would be against the public interest to tax utilities except to use them as collectors of a tax-free surcharge on bills to customers. In the case of *McCulloch* v. *Maryland* the problem of conflicting tax jurisdiction between State and Federal Governments was considered. The situation is now reversed, with the Federal Government taxing a State creature. A legal test case carried through the courts might decide this question.

CONCLUSION

The Government urgently needs more revenue. The utilities are eager to pay their share. But in the process the industry should not be threatened with destruction. Here is a $15,000,000,000 industry whose shares, preferred and common, are held by over 2,000,000 citizens, private investors, and whose bonds are held directly by over 1,000,000 citizens and indirectly through the life-insurance companies and the savings banks by over 40,000,000 American citizens. Destroying this industry will have a grievous effect on millions of American citizens and voters.

It should be possible to work out a sound method for the taxation of utility income that will safeguard the credit of the industry, permit efficient utilities to continue to operate as private enterprises, and yet enable these companies to provide low-cost and plentiful service for the period of economic reconstruction after the war.

WARTIME TAXATION: INTERNATIONAL EXPERIENCE CONCERNING TREASURY PROPOSALS AND THE REVENUE BILL, SUBMITTED BY ELISHA M. FRIEDMAN, NEW YORK, N. Y.

Summary of proceedings of conference at New York University Faculty Club, May 26, 1942, of industrialists, bankers, economists, as well as Government officials and ex-officials from Great Britain, Canada, Germany, Austria, Czechoslovakia, France, Belgium, Holland, Sweden, and Switzerland, who were questioned by United States Government officials attending. The chairman was Elisha M. Friedman.

This summary will cover: (1) Taxes on individuals, income tax, wages tax, sales tax, estate tax, and capital gains tax; and (2) taxes on corporate income, excess profits, and increment income.

I. PURPOSES OF WAR TAXES

General experience shows that in this war all countries raise a higher percentage of war costs by taxation than during the last war. However, one cannot always tell whether financing by taxation is preferable to financing by borrowing. Two arguments usually are brought forward in favor of borrowing: (1) Borrowing emphasizes the voluntary element in war financing and offers, therefore, a greater chance to attract idle money. The problem remains, however, whether real and additional savings can be obtained or whether only a replacement of other assets takes place; (2) the old argument is still valid that borrowing lays a part of the financial war burden on future generations which should not only share in the blessings of the victory but also in its costs. The degree, however, to which this really can be accomplished depends to a great extent on whether large-scale borrowing will result in inflation or not. Inflation, which is actually a form of taxation, would throw back a greater part of the borrowed burden on the shoulders of the present generation. On the other hand, it cannot

be presupposed that taxation is a sure way to avoid inflation. The line of demarcation between inflationary and noninflationary methods of war financing does not run between taxation on one side and borrowing on the other. In fact, it depends on the specific way in which taxation and borrowing are handled, whether inflation will result or not. The main point is whether war financing succeeds in limiting the purchasing power of the population. Both taxation and borrowing can furnish adequate means to this end.

However, in the modern war economy there are other and more effective means of bringing about this result. If curtailment and control of consumption is the main issue, the experience in Great Britain and Germany shows that this can be achieved more directly and more effectively by rationing and price and wage control than by taxation and borrowing. As a matter of fact, it was the combination of all these means which until now gave fair results in overcoming the dangers of inflation. The tremendous drive for voluntary saving, as for instance, in Great Britain, is a direct result of the absolute lack of goods to buy. In this respect Germany offers a very similar picture.

Finally, there remains theoretically the possibility of checking inflation by directing idle money into forms of consumption or investment which would not interfere with war production; e. g., movies, jewelry, real estate. These possibilities, however, offer either only comparatively small outlets, or they may have dangerous consequences in other fields. Price rises in farm land would raise farm prices and this would not only impair the price policy during the war but also repeat the fact that the high price of farm land was one of the main reasons for the collapse after the war.

Nor is there a definite way of saying how much of the war effort is actually financed by taxation in the various countries. In a total war economy as exists today, not only in Germany but also in England, the total war expenditure exceeds the limits of the budget. Much of the cost of the war effort has to be paid by the population in forms which are neither taxation nor borrowing. In Germany, where this system of additional revenue is most elaborately developed, the greater part of the economic and social administration is financed by voluntary or involuntary contributions. Furthermore, when sections of industry can be induced or compelled to make war investments out of their own reserves and earnings, when private individuals and landlords are obliged to build shelters, hold stocks, etc., on their own costs, then a part of the financial burden of the war is financed apart from any public budget. The problem of fixing the amount to be secured by taxation is complicated by the fact that in all countries Federal or State revenues are complemented State and local revenues and that, aside from taxation, social-security contributions are an additional burden on private incomes.

These factors must be kept in mind with regard to the following figures: It has been estimated that the war expenditures is covered by taxation in Great Britain 40 to 50 percent (excluding lease-lend material); in Canada 58 percent; in Germany 33 to 40 percent; in France (at the beginning of the war) at 35 percent; in Switzerland, 57 percent of the war budget or almost 35 percent of the total Federal budget.

There is some evidence that taxation, even in wartime, is limited politically more than economically. Even in Germany where political considerations least impede the decisions of the Government, the Nazis in their tax policy deemed it necesary, for instance, to favor the workers and applied certain tax measures to them to a less extent than would have been economically possible.

The psychological limits, however, are not fixed boundaries. They can be expanded by political education and an adequate policy. The sequence of political steps seems to be very important in this respect. This is shown clearly by the experience in Canada. There the government had the same factor to face as in this country: to make the public realize that a bitter war is being waged which must profoundly affect every individual. Canada attempted to achieve this step by step. The first step, taken even before the outbreak of the war, was the control of armament contracts. This was followed at the outbreak of the war by an excess-profits tax which took away 75 percent of all excess profits. The third step was widespread propaganda for reduction of the standard of living. The fourth was the introduction of selective price control. The fifth step was taken: the government announced that only average past expenditure would be allowed when the excess-profits tax resulted in useless spending by individuals and companies—as a deduction in computing taxable profits. This applied to wages, salaries, advertising and all other expenses. (To stimulate the defense bond campaign, advertising is treated as an allowable deduction for tax purposes provided at least 80 percent of the space is devoted to

promoting the sale of defense bonds.) The most recent step was the establishment of wage control. This development required a long period of gradual education as to the reality of war. No workman up to the rank of foreman is permitted an increase of wages beyond the amount justified by the cost of living index. No increase in salaries is allowed unless the employee gets a new job. The next step will be rationing. It is regarded as one of the most important modes of controlling consumption. Selective rationing only is at present in force. The rationing of rubber and tires commenced in December 1941.

II. TAXES ON INDIVIDUALS

(A) Personal income tax

1. *Canada.*—All the Provinces have agreed to cease levying income tax for the duration of the war. The Provinces will be compensated on the basis of the yield of provincial income tax for the fiscal year which ended closest to December 1940. The effective rate of income tax is now 50 percent as compared with a pre-war effective rate of 30 percent. Exemption limits have been reduced from the range of $1,200 to $2,400 first down to from $750 to $1,500, and now down to $660 to $1,200. Taxpayers in the lower brackets seem to be willing to share the tax burden.

2. *England.*—Incomes below $440 are exempt from income tax. On incomes subject to tax, the allowance for a single person is $320, plus certificate for a rebate of tax up to a maximum of $80 credited to the taxpayer in the Post Office Savings Bank and payable after the war. A married person's allowance is $530, plus a certificate up to $120. In addition, $200 is allowed for each child. The maximum certificate for rebate is $260. In addition to the above allowances, there is an allowance on earned income of one-tenth of the amount earned, with a maximum exemption under this head of $600. The minimum rate of tax is 32½ percent, which applies only to the first $660 of taxable income. The standard rate of 50 percent then applies. On gross incomes exceeding $6,000, surtax is payable commencing at 10 percent and rising to 47½ percent. The top rate is, therefore, 97½ percent (50+47½ percent), and after making provision for all allowances this works out at a top effective rate of about 95¼ percent. As a result, a man earning $30 a week pays, if single, $444.50, and, if married with two children, $156. A married man with two children earning $5,000 a year pays $1,674 50 (33 percent); if earning $20 000 a year, $11,029.50 (55 percent); and if earning $200,000 a year, $181,378.50 (91 percent).

As a single person earning as little as $480 a year has to pay $30 income tax, the tax of wage earners is deducted from the pay envelope. But for the sake of precision and equity, every worker is separately assessed, on the basis of an individual return of total wages for the year. The employer is notified the exact amount to deduct. Adjustments are made annually to cover variations in the annual tax as a result of changes in the wage rate, or periods of unemployment. The number of returns and assessments of weekly wage earners in 1941–42 was 5,500,000, with a tax yield of $600,000 000, out of an aggregate yield from income tax and surtax of $3,078,500,000. The estimated aggregate yield for 1942–43 is $3,660 000 000. Persons with incomes under $2,000 per year receive forty-three fifty-sevenths of the aggregate gross incomes of all persons. Persons with incomes under $1,000 per year would pay an average actual rate of income tax equivalent to 3.1 percent of their incomes. Persons with incomes of over $1,000 and under $2,000 would pay an average of 14.9 percent. In spite of the magnitude of the administrative task, the system works, and there are no inequities due to short cuts or simplification.

Joint returns are always required. Deductions are allowed for life-insurance premiums. Deduction at source is made on payment of rent, interest (except bank interest, in respect of which the payer gets a rebate of tax), annuities, and dividends. However, where the deduction is made out of income (e. g. mortgage interest payments, dividend payments), which has already been brought into charge for tax, the person deducting the tax does not account to the revenue authorities for the amount deducted, because in England no income is taxed twice. Income tax is payable on real property and normally the tax is computed on the assessed rental value, even though the property is occupied by the owner. But property which is wholly unoccupied is not subject to tax (nor is it subject to local taxation). The effect of high rates of tax on incentive is watched, but in wartime this is a much diminished factor. Allowances for depreciation and obsolescence have been increased to meet the exceptional circumstances of war production.

3. *France.*—The amount exempt from income tax was about $400, but this exemption applied to only wages and salaries. The rate of tax ranged from 18 to 40 percent, according to the source of income or class of security. The rate was lower on wages and salaries. On income derived from foreign securities, the rates on dividends were lower for registered shares than for bearer shares. The tax on interest and dividends was borne by the owner of the security and it was deducted at the source, but the corporation was entitled to assume the burden of the tax on debenture interest.

Payers of surtax were entitled to a deduction of $400 if single and $520 if married, and those with dependents enjoyed the advantage of slightly lower rates of tax. The highest rate of surtax was 36 percent. Rates were uniform for all sources of income.

Deductions were permitted for life-insurance premiums. The most productive bracket was the middle bracket, about $5,000 per year. Normally, husband and wife had to file joint returns, but there were exceptions. Taxes on nonresident foreigners were deducted at the source, but they were not subject to supertax.

4. *Belgium.*—The exemption is about $550 (15,000 francs, assuming a purchasing power of 3.7 cents), with an additional exemption of 10 percent if married, and 20 percent for each child. The minimum rate is less than 1 percent, and the maximum rate, on incomes above $300,000 is 22½ percent. The rate payable on dividends is 22½ percent, and on interest, 12 percent. Supertax is levied at a maximum rate of 16 percent, but is payable only on the balance of 77½ percent of the income after payment of income tax at 22½ percent. Dividends from foreign sources are taxed at 9½ percent, but foreigners deriving income from Belgian sources are not granted different treatment from Belgians. There is an allowance for life insurance. A refund is payable in respect of unoccupied real property.

5. *Holland.*—The exempt limit was $400 for a married couple and no deduction was allowed for children. The minimum rate was 2 percent, and the top rate was 45–46 percent. Uniform rates were levied whatever the source of income. The total yield from income tax was only 10 percent of the total tax revenue. A tax of 10 percent was deducted from dividends.

The tax on dividends or interest coupons payable to foreigners was only 2 percent, and it was deducted at the source. The purpose was to encourage investment by foreigners. Foreign corporations operating in Holland paid tax only on profits made in Holland, and the tax was approximately equivalent to 10 percent of the dividends paid.

There was no withholding tax on wages. Joint returns were always required. Life-insurance premiums were entitled to a small exemption of $55.

6. *Sweden.*—The exemption for a married person is $250 (1 kroner is taken at 25 cents; the par value is 23.8 cents and the purchasing power is about 40 cents); with one or two children, $500; with three children, $750. The minimum rate is 8.1 percent, which includes income and property tax and the new defense tax which is now equivalent to 50 percent of the income tax, but is proposed to be increased to 62.5 percent of the income tax in 1942. The maximum rate is 53.7 percent on incomes exceeding $50,000, and this includes a surtax of 28 percent. The average aggregate rate on an income of $1,000 is 24.69 percent; on an income of $2,500, 32.60 percent; and on an income of $6,250, 46.92 percent. In the case of income wholly earned, the maximum effective rate is 45 to 50 percent. But on unearned income with an assumed yield of 3 percent, the rate in respect of property valued at $1,250,000 would be about 72 percent. A novel provision is a discretionary allowance of the whole or part of the defense tax in cases of illness, unemployment, military service, or retirement.

Joint returns are required. No deduction is made from wages, except in cases of default in payment of the previous year's tax. Tax is payable on the assessed rental value of real property, but assessments are on a moderate scale, and investment in real property is a lawful mode of relieving the burden of high rates of tax.

7. *Germany.*—In Germany all wage earners and salaried employees are subject to a special wages tax in lieu of income tax. The lowest rate of the income tax applied before outbreak of the war was 1.7 percent, the highest 55 percent. Immediately after the beginning of the war a surtax of 50 percent on all incomes, including wages and salaries, but excluding corporations, became effective. Small incomes up to 2,400 reichsmarks annually were exempted from the surtax; for wages and salaries the limit was 2,800 reichsmarks. Until

the end of 1941, when slight changes were made, the exemption from income tax was $373 (approximately 1½ reichsmarks equal $1 in purchasing power) for a single person, $550 for a married person in the first 5 years of marriage and $450 thereafter, and additional exemptions of $200 for each of the first two children, $267 for the fourth child, and $333 for the fifth child. The minimum rate is 2.5 percent for a single person, but the minimum rate decreases in respect of married persons with children on the basis of the larger the number of children, the lower the rate. The minimum rate for a married person with four children is a mere 0.28 percent. The maximum rates, which are levied on incomes of $90,000 or more, range from 65 percent for single persons to 55 percent for married persons with children.

The tax payable is ascertained from a comprehensive tax table. The above figures are derived from the table and include the war surtax.

There is a separate income tax for wage earners, who are not taxed under the above individual income tax unless their wages exceed $5,333 per annum (8,000 reichsmarks). The tax is deducted from the weekly wage, with no refunds or adjustments. Exemptions range from $676 per annum for a single person to $2,080 per annum for a married person with four children. Minimum rates are from 1.18 percent down to 0.26 percent and maximum rates on incomes of $24,667 and over are from 40.5 percent down to 22.5 percent with corresponding advantages for married persons with large families. Incomes derived from salaries exceeding $5,333 are assessed under the individual income tax, subject to a credit equivalent to the amount of wage tax which has been deducted.

Since October 1941 wage earners may open "iron savings" accounts, with maximum deposits of $17 monthly, or 50 percent more if the wage earner works overtime, and with the addition of bonuses up to $333. These "iron savings" receive interest at 3¾ percent, and are exempt from wages tax and social insurance contributions, but the accounts are blocked until 12 months after the war. In form, the scheme is voluntary.

Tax on dividends and interest is deducted at source. Joint returns are not required. Wage earners having unearned income not exceeding $267 derived from dividends or interest, or $267 from rent, and not exceeding $667 in the aggregate, need not file a return, but receive no rebate in respect of tax deducted at the source, although the rate at which tax is deducted amounts to approximately 27 percent in the case of single persons, 21 percent if married, and 15 percent if having one child. There is no allowance for life insurance.

8. *Italy.*—Income tax is not important in Italy. It exists, but is not taken seriously. Returns are usually low, and are seldom accepted at face value. More often, the assessment is based on the standard of living of the taxpayer, which, at least, imparts the salutary character of a luxury tax. The rate on dividends is 10 percent. Wages of $40 per month and over are taxed. Real property is assessed on rental value, and the tax is payable whether the property is occupied or vacant.

B. Wages tax—deducted at source

In Germany wages tax, deducted at the source, has existed for 20 years, and in Belgium for 15 years. In Germany the wages tax replaces the income tax for all wage and salary earners earning up to 8,000 reichsmarks annually. In these cases no income-tax returns have to be filed, no assessments take place, and no refunds are made. Returns have to be filed, however, if the wage or salary earner has other earned income of more than 300 reichsmarks, or capital income of more than 1,000 reichsmarks annually. Since 1933 Germany deducts the wages tax with the help of tax tables providing for pay periods per month, week, day, and 2 hours, carrying through the progression of the tax rate up to 27 percent for unmarried and 15 percent for married persons. Elaborate exemptions for family members are granted.

In Belgium deductions from wages and salaries and directors' fees are made by schedule, according to the number of dependents, and progressively according to the amount earned. Any necessary adjustment is made in the final income tax.

In France deductions have long since been made from dividends. Deductions from wages are a wartime innovation. There are two classes at fixed rates.

In Great Britain deduction at the source from dividends, rents, and mortgage interest at the standard rate has long been in force, and has worked well. The taxpayer claims a rebate for reduced rate of tax and allowances. Deduction

from wages and salaries at the source was introduced in 1941. The deduction is made in respect of the tax payable on the current wages of salary, and reaches 4,000,000 taxpayers. It works well.

Experience with the new wages tax in Canada is favorable. Applications for refunds by persons who paid on short periods of employment but who were not fully employed during the year were far less numerous than expected. Germany had the opposite experience with refunds during the twenties and abolished them in 1931.

C. Sales tax

The sales tax can be applied in three different forms: Manufacturers' tax, general turnover tax, and retail sales tax. The manufacturers' tax exists in Canada and France, the general turnover tax in Germany and Belgium. Great Britain has recently introduced a sort of wholesale tax. Canada and France now apply the manufacturers' tax in much the same way. Both countries take the tax in general from the last manufacturer of each article. In other words, the tax is raised before the merchandise is taken over by commerce or reaches the consumer. No accumulation of tax rates takes place.

1. *Canada.*—All taxpayers are registered. There are many exemptions, e. g., processing, staple articles, ingredients. The amount of the tax must be shown on the manufacturers' invoice to the retailer. The tax is found to be simple and nonirritant in practice.

2. *France.*—The development was characterized by frequent changes in the technique of sales taxation. The original retail sales tax met such great opposition from small shopkeepers and handicrafts that it had to be replaced very soon by the "taxe sur le chiffre d'affaires," a general turn-over tax. This system, however, was likewise so unpopular among small retailers that step by step it was replaced, in part, by separate taxes on various products. These were the so-called "taxes uniques," which were applied mainly in the form of manufacturers taxes. Every product subject to a "taxe unique" was exempt from the general turn-over tax. In 1936, after the People's Front had made an election promise to abolish the sales tax, a new system was created. Some of the numerous "taxes uniques" were combined with the consumers taxes; some of them with the customs duties and a few remained. The general turn-over tax was converted into a manufacturers tax, "la taxe a la circulation des produits." Two tax rates are applied in this case: A general rate of 8.7 percent and a rate of 2.2 percent applicable to all small business concerns, the turn-over of which does not exceed 300,000 francs. Also, this system had to face much criticism. The tax was concealed from the consumer, and not unpopular with him; but it was unpopular with the last manufacturer, who was the ultimate payer, and whose liability was computed from his books.

3. *Germany.*—There is a general turn-over tax which in 1938–39, the last pre-war budget, netted 3,400,000,000 marks, or about 18.9 percent of the total tax revenue of the Reich. Since 1932 the general rate is 2 percent. Farm products, however, pay only 1 percent. The tax rate on wholesale trade is 0.5 percent, and on department stores 2.5 percent. Every turn-over is taxed. The tax has to be paid every month, but in the case of small shopkeepers every 3 months. Administrative experiences are favorable. A stringent system of control has been established. Before 1933 criticism against the tax was frequent. It resulted in a gradual reduction of the tax rate from 2.5 percent in 1924 to 0.75 percent in 1926. During the depression, however, the tax rate reached again 2 percent.

4. *Belgium.*—The turn-over tax was the backbone of the budget, and was found to be a satisfactory form of taxation. It was steady, popular, and a powerful check to inflation. It resulted in increased prices, but the Government got the bulk of the increase. The luxury tax was not a great success, owing to collusion, and evasion by false descriptions. The fundamental tax, was a tax on everything sold (except imports and exports) imposed at every stage and imposed every time the article or commodity turns over. The rate was generally 3 percent, but in some cases 1 percent. The tax was an incentive to the integration of firms in order to reduce the number of turn-overs, because every added process by an independent firm was regarded as a fresh turn-over to the extent of the added value. The incidence of the tax is normally on the ultimate purchaser. No turn-over tax is payable on sales by farmers.

5. *Great Britain.*—The so-called purchase tax, is a wartime measure. Its main object is to curtail consumption, not to produce revenue. The tax is restricted largely to articles which are not included in the cost-of-living index. It exempts food, and standardized or so-called utility clothing, boats, shoes, etc. Under conditions of total war, taxation is based upon an estimate of the minimum living requirements of the public. The rest must go into the war effort. This is possible only when the "sacrifice" factor is sufficiently strong.

The revenue derived from the purchase tax for the first 6 months of its operation was $104,000,000 and $394,000,000 in 1941-42. The rate of the tax is 16⅔ percent on classes of goods regarded as more essential, such as pots, pans, brooms, earthenware, and ordinary clothing; and the rate is 33⅓ percent on goods regarded as luxuries in wartime, such as soft furnishings, bedding, cutlery, furniture, and household appliances.

The tax is levied once only. It is chargeable on the wholesale merchant or manufacturer, who adds it to his invoice to the retailer, and the retailer, in turn, collects the amount of the tax from the consumer on sale. The tax must be separately shown on the invoice. It is also kept separately in the books of account, thus simplifying administration. The person accountable to the Treasury is the wholesaler or manufacturer, who must be registered. There are 40,000 registered traders, but this number may be increased because the lower limit of annual turnover required for registration has now been reduced to 500 pounds.

The rates have now been doubled, but the exclusion of utility clothing will minimize the effect of the increase on the cost-of-living index. Some of the principal articles now chargeable with tax at 66⅔ percent are silk garments and fabrics, pile fabrics, soft furnishings made of such fabrics, mirrors, leather luggage and wallets, clocks, watches, musical instruments, toilet requisites (excluding a few essentials such as brushes, combs, towels, and razors), and ornamental articles.

The tax has added about 12¼ and 24 percent respectively to retail prices, and has caused a rise of 5¼ points in the cost-of-living index, which had been restricted to 125 or 130 points as compared with 100 points prewar. The actual rise in retail prices has been 45 points according to the method of computation in use, but this represents about 29 percent in the cost of living. It is recognized that taken alone the purchase tax has some element of inequity in its incidence, but equity is restored by the system of allowances in respect of income tax.

Labor has not been hostile to the tax. The cost-of-living index rose an average of only 2 percent in 1941, owing to price control, as compared with a rise of 27 percent during the first 16 months of the war. Rates of wages also rose about 29 percent as compared with September 1939, but actual wages received after allowing for overtime and payment by results, increased about 42 percent. Moreover, as stated above, the purchase tax largely excludes items which make up the bulk of the wage earner's cost of living.

6. *Characteristics and use of each type of sales tax.*—Each form of the sales tax has its own merits and shortcomings. The final judgment of the sales tax, of course, depends not only on the solution of many complicated problems involved in its application, but on its position in the tax system as a whole. Since the burden of the sales tax is generally shifted to the consumer it is important that within the existing tax system, an adequate counterbalance be provided in the form of a progressive income tax, an excess profits tax, etc.

Furthermore, from the economic aspect, it is important that the sales tax fits into the whole system of economic policy. Nothing is achieved if the sales tax results in wage increases or if it overthrows a policy of price fixing.

Under present conditions in the United States, a general sales tax might make price-control difficult. Inequity in the incidence of the tax arises from inability to adjust the tax to differences in family responsibility. This difficulty was compensated in France by additions to wages and salaries graduated according to the number of dependents. An elastic wage system, based on the cost of living, however, absorbs the deflationary effect of a sales tax.

In Germany and in France the tax was concealed from the consumer with the result that competition absorbed a part of the tax, and the consumer was tax unconscious. It is doubtful, however, whether this result can be expected of a sales tax, introduced during war times. In England, for instance, competition is a weak factor because of the total war economy and particularly the restriction in the production of goods and control of prices.

According to the general trend of foreign experience, a sales tax is not a difficult tax from the economic or administrative standpoint, but it tends to

become a subject of political controversy. Financially, it has desirable tendencies. In some of its forms it creates a consciousness of participation in the burdens of government, which has educational value, but makes the tax unpopular.

The general turn-over tax provides a high yield at a comparatively small tax rate. It is not true, however, that in case of a multiple turn-over tax the tax burden multiplies according to the number of transactions or turn overs. In the initial stages of production the value of an article is only a small fraction of its final value and also the additional turn-overs involved in the progress toward completion of an article result in less than proportional increase in the accumulated tax.

Technically the tax has favorable features. Sales are easily determined, as compared with income. The tax has certainty. But it was found necessary to grant exemptions on intermediate stages of manufacture, and the produce of the tax suffered. Certain technical difficulties had to be overcome—how to handle the tax in cases of import and export; how to fix the tax rate of the wholesale trade; and how to eliminate the effects of integration of the tax. On the other hand the general turn-over tax has one advantage over other forms of the sales tax. Since it is applied to every stage of production and distribution, it provides, if properly handled, the tax administration with a very useful controlling device for income taxes and business taxes.

In the case of a manufacturers' tax the number of taxpayers is comparatively small. The control of the taxpayers is further facilitated by the fact that in general it is easier to educate producers to carry on reliable bookkeeping than the average small retailer. The tax does not induce integration and the export and import trade can be exempted completely. One of the remaining problems is to decide at what stage the tax should be fixed.

Canadian experience shows that a manufacturers' sales tax is noncumulative, nonregressive, simple of collection, can exempt basic necessities, and raises no serious objections, and when disclosed on the bill, gives knowledge of the responsibilities of Government, and creates confidence. In the latter respect, it is analogous to the deduction of income tax at source. But paradoxically, Canada considers it desirable that the ultimate consumer (who is not the direct payer), should not be conscious of the tax.

In the light of the French experience with the general turn-over tax and, after 1936, with the manufacturers' tax, preference is given to the retail sales tax. From this point of view the manufacturers' tax and the turn-over tax have the following disadvantages:

(*a*) In wartimes, when a large part of the production is in the final analysis paid for by the Government, it is not reasonable to increase the cost of all contracts by the amount of the tax. This seems especially devoid of sense when a large part of the contracts is on the cost-plus basis.

(*b*) Even in times of peace both taxes have the inconvenience of being necessarily included in every calculation of the cost price, so that the margin of gross profit applied to every cost price is also applied to the amount of the tax, which increases unavoidably the profit of the manufacturers, the wholesalers, and the retailers. In Germany this disadvantage has been overcome by a rigid price control.

(*c*) Distribution by the retailer is the only field where there may be some competition in wartime. Therefore it is possible that part of the tax would be absorbed by the retailer out of his gross-profit margin. The increase in turn-over resulting from the increasing prices and from the greater purchasing power of the masses makes such absorption easier.

(*d*) Forms of "consumers' taxes" where the maximum incidence on the prices can be easily calculated are preferable to other forms. Such an approximate calculation is only possible with a retailers' tax.

(*e*) The only advantage of the manufacturers' tax is that the number of taxpayers is comparatively small and bookkeeping of the manufacturers is generally more accurate. With the general use of the income tax, however, the retailers are now quite used to bookkeeping and tax reports and should have no difficulties in reporting their monthly turn-over.

(*f*) The retail sales tax should begin with a low tax rate, which can be increased gradually later on.

On a vote as to the most desirable form of sales tax, out of 24 persons present at the conference, 7 voted for a manufacturers' sales tax as in Canada, 5 for a tax paid by the retailer, and 5 for a general turn-over tax payable at every stage and cumulative as to the added value. The purchase tax of Great Britain was regarded as sui generis and was excluded.

D. Estate and gift taxes

1. *England.*—Death duties may be divided broadly into estate duty, payable on the aggregate estate, including gifts made within 3 years of death, or in the case of gifts to government, made within 1 year of death, and legacy or succession duty, payable by beneficiary.

For estate-duty purposes the exemption is $400. The rate of duty then commences at 1 percent and rises on a long, graduated scale to 65 percent on estates exceeding $8,000,000.

The minimum rate of legacy or succession duty is 1 percent, and the maximum is 10 percent, computed on the value of the legacy. The rates are uniform for all legacies, whatever the amount or value, but vary according to the degree of relationship of the recipient to the deceased.

Gifts to the state in 1941 amounted to $84,000,000. Death duties yielded $363,000,000 in 1941–42, and are estimated to yield $360,000,000 this year. Existing rates are only slightly above pre-war rates.

The high rates of estate duty have resulted in the breaking up of a large proportion of the big, landed property in England, but heavy income tax has also been a factor.

2. *France.*—The whole legacy or portion from $400 to $6,000,000 was subject to tax. (One franc equals about 4 cents, which was the par value at the time the laws were enacted and was close to the purchasing power before the war.) Each child after the second was entitled to a deduction of 10 percent, not exceeding $800 per child. Peasant owners with estates up to $2,000 were exempt or paid lower rates. Rates also varied downward according to the number of surviving children. Charitable gifts, with exceptions, were taxable at the rate applicable for persons not related to the deceased.

The minimum rate was 1 percent for direct descendants, with two or more surviving children, and rose as the degree of relationship receded to a minimum rate of 32 percent for strangers. On gifts between living persons, the rate ranged from 3.25 percent in the case of direct descendants to 52 percent in the case of strangers.

The maximum rate for more than two surviving children was 40 percent, and for strangers was 80 percent. The rates in the different categories increased according to a rising scale based on the value of the estate.

For gifts, the maximum rate for direct descendants was 12.5 percent. For all other classes, the maximum was 52 percent.

Where there were more than four children, no inheritance tax was payable by the heirs but the estate paid a global tax.

There was an over-all maximum. In a direct line, or between husband and wife, the tax could not exceed 25 percent of the portion of each beneficiary; in collateral line, 40 percent; other relatives and strangers, 50 percent.

Increases in the rates proved unfortunate. Fraud increased; yield dropped.

3. *Belgium.*—There is no estate tax. The minimum rate of inheritance tax for spouses or direct descendants is 1.25 percent, and the maximum rate for over $370,000 is 14 percent. (One Belgian franc is taken as 3.7 cents in purchasing power.)

For remote relatives and strangers, the rates range from 16 to 60 percent.

Exemptions for spouses with children or direct descendants or ascendants are shares not exceeding $259. All shares derived from estates not exceeding $129.50 are exempt, as are legacies to the State. A special deduction of 4 percent of the tax is allowed to spouses for each child, and a similar deduction of 2 percent per child to all other beneficiaries. Legacies to certain institutions serving the public interest are subject to a tax of only 6 percent, and nonprofit organizations 8 percent.

4. *Holland.*—The exemption from inheritance tax in the case of inheritance in the direct line or by spouses is $550, but in the case of children under 21, the exemption increases by $165 for every year below 21, and the spouse enjoys the same exemption as the youngest child. Other legal heirs are exempt up to $165, and strangers, $55.

Gifts by parents to children are exempt up to $1,100, and in the year of the child's marriage, up to $5,500. Married children enjoy a higher exemption, up to $2,750, graduated according to the parents' income. Gifts within 1 year are aggregated.

There are absolute exemptions from death duties in the case of gifts to the State, certain pensions to employees, annuities to employees' children, small life-insurance annuities, and gifts to members of the Royal House.

Rates range from 2.5 percent to a maximum of 7 percent for children or spouse; and from 28 to 37 percent for distant relatives and strangers.

5. *Sweden.*—The minimum rate for a spouse or direct descendant is 1 percent on $750 and 2 percent on the balance up to another $750. The maximum rate is 13.5 percent on $100,000 and 20 percent on the balance where the inheritance exceeds $100,000. Legacies below $750 are exempt. Exemptions are higher in the case of testate estates; namely, on distributions to husband and wife, one-half of the estate is exempt and any share due to a spouse out of the remaining half if such distribution does not exceed $6,250. Children under 18 are exempt up to $750 plus $250 for each year below 18. Gifts received within 4 years of death are aggregated and included in the estate with credit on estate tax for gift tax already paid.

For distant relatives and strangers the rates range from 4 percent on bequests of $250 to 14.725 percent on the first $10,000 of gifts of that sum or more, and 35 percent on the balance. Certain charitable and public institutions are wholly exempt, but most religious, philanthropic, and public associations pay a minimum of 4 percent on a gift of $250 and a maximum of 33.725 percent on a gift of $15,000 or over, and 30 percent on the balance in excess of the first $15,000.

6. *Germany.*—There has been no estate tax since 1923. There is an inheritance tax which applies also to gifts.

Husband or wife, if children or grandchildren survive the deceased, are exempt. If no children survive, husband or wife are exempt as to the first $20,000. Children enjoy the same exemption. The exemption for grandchildren is $6,667.

Certain relatives have exemptions of $1,333 and other persons, $333, but these are not absolute exemptions. Tax is payable on the full amount of the inheritance subject to a limit of one-half of the amount by which the inheritance exceeds the exemption.

Charitable gifts are exempt.

The rates vary according to the degree of relationship and the amount of the inheritance. Minimum rate for husband, wife, or children is 2 percent and maximum 15 percent. For distant relations and strangers the minimum rate is 14 percent and the top rate is 60 percent. The highest rates apply to inheritances exceeding $6,666,667. Gifts made within 10 years of death are aggregated and included in the estate, and tax already paid is credited on estate tax. The yield aggregates 3.6 percent of all the revenues of the Reich.

E. Capital gains tax

There is no tax on capital gains in Great Britain or Canada. Before the war there was no capital-gains tax in France, Holland, Belgium, Denmark, and Norway.

1. *Germany.*—A capital-gains tax existed as a Prussian tax since 1891, as a Reich tax since 1920. It was applied since the beginning on capital gains from speculative operations in real estate and securities. First the tax department had to prove the intention to speculate of the individual buying and selling real estate or securities. Since 1925, however, a transaction was considered a speculative operation if the real estate was resold within 2 years or the securities within 3 months after purchase. Since 1934 the latter period has been extended to 1 year thereby widening the term "speculation" considerably. On the other hand, gains from transactions in securities having a fixed interest rate were declared exempt. Losses can be deducted only from gains which accrued to an individual from speculative transactions in the same year. Speculative gains remain tax-free if the total annual amount does not exceed 1,000 reichsmarks.

In 1939 the liability of gains from speculation with securities was suspended but reintroduced at the beginning of 1941.

Gains from speculative operations are part of the total taxable income. There is no provision for specific tax rates.

It has been estimated that the taxation of speculative gains yields only a few millions annually, the total gains from speculative operations on the stock market in 1936 being estimated at 100,000,000 reichsmarks.

2. *France.*—The capital-gains tax was enacted after the German invasion as a consequence of a considerable rise in French stock prices, due both to purchases for control from German sources and to an inflation psychosis of the French public. The original law introduced after the German invasion levied a tax of 33 percent on all capital gains without limit as to time of holding of the securities. It produced no revenue and froze the markets. By February 1942, however, the law

was rapidly and successively revised in order to produce revenue and to break the frozen markets. The rate was reduced from 33 percent to 20 percent, and then to 10 percent. The holding period was reduced from unlimited to 12 months and then to 3 months. At present capital gains taken after 3 months are not subject to any tax. Capital gains realized within 3 months pay 10 percent. However, this tax applies only to securities. Real estate and farms are exempt. Capital gains are not included in the general income tax. It is a special tax on a special profit, "impot cedulaire." Therefore, although the general income tax is graduated, the tax on capital gains, taken within 3 months, paid a flat rate.

3. *Holland.*—The Dutch always opposed the capital-gains tax because they felt it was a detriment in any system of private enterprise and particularly so for the development of new companies and new industries. Being deeply religious, the Dutch prohibit betting, slot machines, gambling of all sorts, and horse racing. But they made no attempt to check risk taking for economic motives. Therefore, they have no tax on capital gains. Germany, however, introduced a capital-gains tax in Holland in May 1941.

4. *Great Britain.*—Britain was the home of the industrial revolution and developed capitalism earliest and most extensively, refused to incorporate a capital-gains tax in its tax system. The income tax was introduced in 1842, but the capital-gains tax was never levied. Not that it was ignored or overlooked. A Royal commission studied the question and rejected the tax. Today in war, Great Britain has a 100-percent excess-profits tax, a very heavy income tax on low incomes, a tax on wages—deducted at the source, a sales tax, all introduced under a government in which labor is powerful. But there is no capital-gains tax.

5. *Canada.*—The above comment applies with equal force to Canada. Though geographically our neighbor and exchanging many economic ideas with us, it has no capital-gains tax. Its tax rates and burdens are far heavier than in the United States, but they follow the English pattern.

6. *Conclusion.*—General experience with taxes on capital gains shows that tax evasion is simple and general. People merely do not realize gains. Nevertheless, the evil influence of the tax on capital markets is frequent, especially at extremes—top and bottom.

From the economic point of view the tax tends to discourage sound, as well as unsound, speculation. From the fiscal point of view, it introduces a factor of instability in the public revenue since the inclusion of capital gains amongst taxable income excessively increases the yield of income taxation when markets are rising, and the inclusion of capital losses excessively reduces it in years of depression. Moreover since in the aggregate losses approximately equal gains, and probably even exceed them, the net outcome is at best insignificant and may even be a minus quantity.

III. TAXES ON CORPORATIONS

A. Taxes on producers of war materials

In order to maintain the equality of contribution and sacrifice, to obtain a maximum of labor cooperation and to reduce to a minimum demands for higher wages, high tax rates on business concerns are unavoidable in wartime. It has proved necessary, however, to diminish economic disadvantages resulting from these high rates by enlarging the allowances for depreciation. This is especially necessary for specific war production where invested capital must be written off in a short time. Great Britain, Canada, France, and Germany followed the same line in this respect. Canada has set up a War Contracts Depreciation Board, headed by a judge, to determine independently the amount of depreciations. For new capital used for war purposes, depreciation rates of 20 to 50 percent are often granted. Ever since 1933, in Germany in Reich Finance Minister has had the authority to grant complete exemption from current taxes, for enterprises developing new technical processes and new products.

It has to be taken into consideration, however, that in most countries, aside from taxation, stringent regulations for the limitation of war profits are in force. England has had good experience in this respect and Germany went even a step further by concentrating her efforts not only on the "skimming off" of profits on war contracts, but also on keeping all costs of war production as low as possible.

Also, it is desirable to avoid the destruction of incentive in wartime. When taxation reaches levels which are regarded as confiscatory, incentive is lost. But this war has introduced a factor, which may be called the sacrifice factor, which extends beyond mere willingness to pay high taxes. The importance of the

individual has diminished in his own eyes, and the interests of the state overshadow the possessive instincts of the citizen. In Great Britain, the Government watches the reaction of the taxpayer. If incentive appears to be lacking or declining, the necessary tax reductions are made.

B. Taxes on corporation income

1. *General observations.*—In considering whether fiscal measures are sound in practice, regard must be had not only to principles and methods of taxation, but also to rates. It is proper to distinguish earned income from income from investments and more especially to differentiate between profits derived from business and investment income. Firstly, business may result in losses, in contrast with investment income which, at the worst, ceases to exist. Secondly, whereas investment income is always in cash, business profits are to a varying extent represented by inventory, receivables, and fixed assets. It follows that there should be a carryover of losses, and if taxes be levied on businesses as such, the maximum rate should be at a moderate level.

A corporation tax, imposed as a separate tax, and in addition to an income tax on the eventual recipient of the distributed profits, is, in effect, a preliminary tax on collective income derived from the corporate form of conducting business. The distributed income is caught a second time on payment of income tax. A corporation tax is, therefore, regarded by some as a counterweight to the disadvantages of conducting an unincorporated business; by others, as a penalty upon the mode of business most conducive to enterprise and efficiency, and the form of organization which has been the life of United States industry. It has, however, the effect of trapping undistributed profits.

The incidents of the American corporation tax is upon the equity capital with curious consequences. The whole burden of the tax falls upon the common stock. To the millions of small investors in common stocks, the corporation tax is a burden of a regressive character. The flow of basic capital to private enterprise in corporate form is discouraged. In order to pay a preferred dividend of 5 percent, a corporation must earn 6.25 percent on its preferred capital if the corporation tax is 20 percent; it must earn 10 percent on its preferred capital if the corporation tax is 50 percent.

These considerations make it desirable to inquire whether there is a practicable method of taxing undistributed profits without the inequities and distortions caused by a corporation tax. In England undistributed profits are made subject to tax in exceptional cases where omission to distribute is a form of tax evasion; but this is merely closing a gap in the net of existing income tax and surtax. Perhaps the assumption that it is desirable to tax all undistributed profits is open to question. In an economy based on private enterprise, conservative finance requires that a proportion of the earned profits be ploughed back. It is at least clear that in determining whether on the whole a corporation tax is a sound fiscal measure, the rate of the tax is a prime factor. It is a matter of controversy whether a moderate rate of corporation tax is a desirable form of taxation, but a high rate is unsound.

2. *England.*—There is no tax as such on income of corporations. This would be regarded as double taxation. Corporations pay the individual stockholders normal income tax on the whole of their profits at the standard rate of 50 percent. In exceptional circumstances, undistributed profits become subject to surtax, as a check on evasion.

3. *France.*—In addition to the tax deducted from dividends, corporations were subject to a tax, but it never exceeded 15 percent.

4. *Belgium.*—There is no duplication of tax on income in the form of taxes on corporate enterprise. A company pays income tax on the whole of its profits. The rate up to 1939 was 26.4 percent. When making a distribution of profits, the company deducts tax and charges the amount deducted against the aggregate tax due to the State. A company may pay its dividends free of tax. In the hands of the taxpayer, the dividend is aggregated with the remainder of his income for the purpose of progressive taxes.

5. *Holland.*—It is noteworthy that prior to the occupation there was no corporation tax, but corporations paid a tax on dividends of 10 percent, with no credit to the payee against income tax. Undistributed profits were not taxed. Now the corporation tax is at the rate of 30 percent.

6. *Sweden.*—There is a corporation tax and defense tax, aggregating 19.5 percent. Charitable organizations pay 9 percent.

7. *Germany.*—The corporation tax on profits up to $33,333 is at the rate of 30 percent; up to $66,667, at the rate of 37.5 percent, and thereafter at the rate of 50 percent. These are not credited against individual income tax as in England.

Since 1941 a special tax has been levied on dividends exceeding 6 percent. On dividends from 6 to 7 percent, the tax rate is one-half percent of the nominal capital; from 7 to 8 percent the tax rate is 1 percent; over 8 percent, the tax rate rises to a maximum of 24 percent for dividends of 12 percent or more. Cash dividends are limited to 8 percent, all earnings in excess being invested by the corporation in Government securities. There is also a tax on capitalized surpluses, at the rate of 10 percent when the capital is doubled, 15 percent when it is trebled, and thereafter at 20 percent. The object is to penalize capital readjustments designed to facilitate the distribution of earnings within the prescribed limits.

8. *Italy.*—The regulations merely affected the distribution of corporation profits, and operated as consumption controls. Dividends in excess of pre-war distributions were limited. A part of the annual profits had to be invested in Government bonds, the sale of which on the market was restricted.

C. Excess-profits taxes

1. *Great Britain.*—The excess-profits tax, originally 60 percent, was raised to 100 percent in response to the demands of labor. At 100 percent incentive was impaired. In 1941, by way of concession, it was enacted that a refund of 20 percent of the tax should be made after the war. The refund is subject to income tax at the rate current at the time of repayment. There is confidence that the refund will be paid. The 100 percent is a magic figure which satisfies labor. The tax is payable on the excess of current profit over the profit earned in one of the pre-war basic periods. This is a flat rate, and not a maximum rate. But there is a kind of minimum or, more exactly, an alternative rate. If the yield of excess-profits tax should be less than 5 percent on the capital in the case of any corporation, or 4 percent in the case of any unincorporated business then, in substitution for the excess-profits tax, a national-defense contribution is payable at the rates of 5 or 4 percent, respectively.

Excess-profits taxpayers have a statutory right to a rebate of 20 percent of the tax, payable after the war, after deduction of income tax at the then current rate, but the rebate may not be used to pay dividends or bonuses to shareholders, and other conditions may be imposed at the time of repayment with a view to diversion of the refund from consumption and using it for reconstruction.

Moderate exemptions are provided in effect by giving the taxpayer the right to elect that his standard profits shall be a specified minimum amount, and this amount ranges from $4,000 to $24,000 in defined cases, with a further discretionary allowance up to a maximum of $16,000, in addition. A board of referees also has power to adjust the standard profits to a higher level where the volume of business in the basic period was less than might have been reasonably expected.

The taxpayer has a choice either of the basic year or group of years, as the standard or base to determine his pre-war profit, and this choice may well be worth a profit of 8 percent on his invested capital. All payers of excess-profit tax are allowed 8 percent per annum on new capital, including borrowed capital, but borrowing is subject to Government control, and this control has the effect of preventing evasion of the excess-profits tax. On the other hand, interest on such borrowed capital is not an allowable deduction for tax purposes.

Businesses recently commenced to compute their standard profits on the basis of a percentage of the average amount of the capital employed; the percentage varies from 8 to 10 percent.

Deficiencies by which current profits fall below standard profits may be carried forward and operate to reduce future profits which are chargeable to excess-profits tax. The amount of the excess-profit tax is a deductible expense in computing profits for income tax.

To avoid inequity by reason of the basic period falling in a bad year, the taxpayer is given limited options to choose a basic period. Notwithstanding the high nominal rate, incentive is preserved by the careful measures outlined above, which permit the taxpayer to retain a modest part of his gains. In any case, the profits motive is now secondary to the victory motive.

In 1941–42 the tax yielded $1,076,000,000. In 1942–43 it is estimated to yield $1,700,000,000.

2. *Canada.*—The excess-profits tax takes away 75 percent of the excess profit over the average profit made during the years 1936–39. If no excess profit was made, a minimum rate of 22 percent of the income for corporations and 15 percent for other taxpayers is applied. Corporations are entitled to deduct the income tax before figuring the excess profit. Sometimes the profits of business concerns carrying on great business activity on a small capital basis are very high. To avoid bad effects of the excess-profits tax in these cases special regulations are applied.

3. *France.*—Excess-profits taxes were limited in principle to a percentage of turnover, but the operation was cut short by the early termination of hostilities.

In 1939 French legislators were preoccupied with the idea, "to take profits out of war." Special fiscal legislation already existed before the war in order to limit strictly the profits from armament contracts. At the beginning of the war new legislation was enacted, the gist of which was to limit any profit to 4 percent of the turn-over.

The consequences were the following: First, many contracts for war production with large firms were delayed owing to interminable discussions about the rate of depreciation to be applied to new equipment. Sometimes production was not delayed, because the industrialists were urged by the government to start and told that an agreement would finally be reached with regard to prices and depreciation rates. But, of course, such a situation did not accelerate building new factories and new equipment.

Secondly, all medium-sized and small industrialists were afraid of not being allowed to earn a sufficient profit to write off the new equipment. Therefore, they did not try to obtain direct war contracts, and, for the same reason, subcontracting, which had reached large proportions in 1914–18, was also greatly reduced. It may be said, that in the first months of this war a large part of French industry remained idle, no "conversion" to war goods took place, and only the largest corporations received contracts and started on war work.

4. *Switzerland.*—It has an excess-profits tax based on the profit of the preceding year and exempting 6 percent of the capital and 10 percent of the excess profits. From the remaining 90 percent of the excess profit 25 percent is taxed 50 percent, and 65 percent is taxed 70 percent.

5. *Belgium.*—There was no excess-profits tax.

6. *Holland.*—There was no excess-profits tax up to the invasion.

7. *Sweden.*—Taxes on profits in excess of the profits of the pre-war basic year range from 50 percent on profits which are 20 percent in excess of the basic period to a top rate of 70 percent on profits which are 50 percent above those of the basic year. This tax applies not only to corporations but also to individual businessmen, the artisans, and to factory workers. Thus it reduces the incentive to press for higher wages.

8. *Germany.*—Germany has no excess-profits tax. An increment income tax on excess incomes from all sources was introduced in 1929, but was abolished in 1940. Since 1941, a profit stop is enforced which operates on the same basis as an excess-profits tax, the intention being to hold down prices and the cost of living. But the profit stop is limited to private consumer goods, government orders being exempt. Incentive to war production is apparently regarded as outweighing checks to inflation or war profits.

9. *Italy.*—There is no excess-profits tax.

D. Increment income tax

1. *Germany.*—It has no excess-profits tax but tried to levy an increment income tax applicable to all incomes including corporation income and wage income. The tax was introduced in March 1939 but rescinded in August 1940. Exemptions were provided for incomes from agriculture, necessary expenditures on enlargements, small incomes, etc. During its short life the tax met much criticism due to the difficulty of finding a fair definition of increment income. Even after the first month of its existence the tax underwent major changes. The rate was cut from 30 percent to 15 percent and the exemptions were greatly extended. First, the increment income tax could be deducted from the taxable income for income, corporation, and business taxes. This provision was abolished when the tax rate was reduced to 15 percent.

2. *France.*—A tax was imposed on overtime wages and salaries at the rate of 40 percent. The tax lasted during the war. Its object was to eliminate the inflationary effect of overtime pay.

3. *Great Britain.*—The idea of an increment tax was turned down. In his 1941 budget speech, Sir Kingsley Wood rejected the tax as being administratively impossible and unfair.

IV. CHAIRMAN'S SUMMARY AND CONCLUSIONS ON NATIONAL EXPERIENCE ON TAXATION WITH REFERENCE TO H. R. 7378

In an international comparison of taxation, the proposals of the Treasury and the House bill H. R. 7378, show unique features. Other countries may have the highest rates for one tax. We seem to have higher rates in the top brackets and lower rates in the bottom brackets for most major taxes. Other countries tap the broad revenue-producing base. They fish where the fish are.

Heavy taxes in wartime are sound. No individual should profit out of a national crisis. Everyone should bear the burden. This is democracy of contribution and democracy of sacrifice. The principle should be universally applied. To apply it to upper incomes only and to ignore it at the lower incomes will produce considerably less revenue no matter how frightening the rates in the top bracket look.

We refrain from levying correspondingly heavy taxes at levels where the revenue stream would be abundant. Why? Uniquely, we have no Federal sales tax. Why? Uniquely, we tax risk taking. Why? Compared to most other countries, we tax production more heavily and consumption less heavily. Why?

1. A corporation tax of 55 percent is the highest in the world. In Germany the tax is 50 percent, but there is no excess-profits tax. The bill, H. R. 7378, fixes a 45-percent tax rate. Our corporation tax deprives the smallest stockholder of income at the same rate as the biggest stockholder, in the lowest income-tax bracket at the same rate as in the highest bracket. It is regressive. It is ruinous to industries with fixed rates like public utilities. The maximum rates in other countries are much lower—15 percent in France, 19 percent in Sweden, 26 percent in Belgium, 30 percent in Canada, and 40 percent in Canada including excess-profits tax. The English and others do not tax the corporation itself, as we do. The British tax of 50 percent paid by corporations constitutes the 50-percent normal individual income tax on dividends, deducted at the source and, incidentally, on the small undistributed profit.

2. The excess-profits tax of 90 percent net in our first war budget is not matched even in the third war budget of Great Britain and the fourth war budget of June 23, 1942, of Canada.

The excess-profits tax is the soundest war tax.

3. The tax bill shows the highest inheritance tax rate in the world, viz., 75 percent. The maximum rates for children and stranger heirs were: Holland, 7 percent and 37 percent; Belgium, 14 percent and 60 percent; Germany, 15 percent and 60 percent; Sweden, 20 percent and 35 percent; France, 40 percent and 80 percent. The top rate in Canada is 28 percent. In Great Britain the top rate is 65 percent on the estate, but an additional tax is paid by each heir on his portion, the maximum of which is 10 percent for a stranger.

In most other countries the inheritance tax rate declines as the number of children increases and rises as heirs are more distantly related.

An estate is built up over a lifetime. An inheritance tax is essentially a long-term tax. It should not be made wholly subject to crisis taxation like excess profits or income taxes. In Canada's budget, inheritance taxes produced 1 percent last year. In the United States it produced 6 percent of gross receipts last year. Such taxation may be good political strategy but destructive economic policy.

4. Our individual income tax rates tax the low levels of income more lightly than Canada or Great Britain and thus allow the large revenue-producing low income brackets to escape.

As stated by Hon. C. Fraser Elliott, K. C., Commissioner of Taxation of Canada, "One should not in a time of crisis and rising revenues occasioned by war leave out of the tax brackets the great body of patriotic citizens who receive low wages, for they desire to pay directly, and the country needs a return out of the substantial aggregate of income which such persons receive."

There are allowances in some countries for insurance premiums and extraordinary medical expenses.

The top surtax bracket in the House bill, 82 percent, is the highest except for Canada's 85 percent but England's 47.5 percent top surtax is over a 50-percent normal rate. The British total top rate is therefore 97.5 percent, the highest in the world. But the British normal tax at the productive base is also the highest in the world.

Our rates are almost the lowest at the bottom incomes where much potential revenue remains untaxed and almost the highest at the top incomes where total tax revenue collected must be small. Does this make fiscal sense?

The surtax begins with us at 13 percent and in Canada at 33 percent. In England the normal rate is 50 percent on income over $660, 32 percent on income over $440.

For a family with 2 children the taxes are paid as follows:

Net income	United States of America	Canada	Great Britain
$1,500		$25	$127
$2,000		107	305
$2,500	$75	217	305
$3,000	162	334	755

Canada also has a compulsory savings plan payable with the income tax. These schedules reflect the fiscal wisdom and the political courage in the three countries.

5. The United States is the only important country in the world that has no sales tax. Soviet Russia derives most of its revenue from the sales tax.

If accompanied by a suitably graduated income tax, a sales tax can be just. If it is not, it must be unjust in a system of private enterprise. But if the taxpaying middle class is impoverished or virtually expropriated, what alternative is there other than a sales tax bearing most heavily on the poorest in a poor society? Herein lies a significant sequence for the rational reformer.

Every government must have revenue. If existing sources are dried up, new sources must be found. If present taxpayers can no longer furnish the revenue, the present nonpaying group in the Nation must assume the burden in the future. If we plan to share the wealth, we may achieve the equalizing the poverty.

6. The United States is the only important country in the world that taxes risk taking—the so-called capital gains and loss tax.

Worse still, the House would tax the results of successful risks within the first 15 months at income-tax rates up to 88 percent, but not grant corresponding deductions to results of unsuccessful risks. What a commentary on the soundness and ethics of the tax. Who will take risks to pay 88 percent? Is revenue the object of the tax?

France had no tax on risk taking. After the Nazi invasion such a tax was introduced. The present rate is 10 percent on gains within 3 months and no tax thereafter. The tax applies only to gains and losses in securities, not to real estate or to farms. It is never confused with the income tax. It is segregated in a separate schedule.

7. Filing of joint returns for husband and wife is a general practice not only in England with its traditions of the common law but in France under the Code Napoleon.

8. There are no tax-exempt government securities except in countries where the national credit was so poor as to require the added inducement of tax exemption.

Great Britain's war taxes are much higher per capita than ours, but they are levied to check consumption but not production. The masses there gladly share in the sacrifice, inevitable to war, by lower tax exemptions, by much higher rates of income tax—50 percent is the normal tax rate—by steep sales (purchased) taxes. England must tax so. So would any honorable recipient of lease-lend goods. But we approximate the British taxes at the high rates where they produce little revenue and we tax lightly, or not at all, where taxes would yield much revenue.

Before the Senate committee actually writes its tax bill, should not a subcommittee carefully review the international comparisons, for their technique, the limits both upper and lower, the current objectives, and the post-war aspects? Should they not ask for estimates of our tax yields if Canadian and British rates were applied? What a flood of revenue should follow.

The facts about tax rates and yields abroad are available. The public must be educated. We are united and mobilized. If the Senate gives its conclusions, who will not heed?

Respectfully submitted.

ELISHA M. FRIEDMAN.

MEMORANDUM ON DOUBLE TAXATION OF ESTATES OF UNITED STATES RESIDENTS, BY ELISHA M. FRIEDMAN, NEW YORK, N. Y.

I. ANALYSIS

Under present law the gross estate of a resident of the United States (including aliens now residing in this country) includes all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States (sec. 811 of the Internal Revenue Code). While the law contains provisions for a limited credit in respect of estate and inheritance taxes imposed by any of the States, there is no provision permitting credit with respect to estate and inheritance taxes imposed by the laws of other countries. Accordingly, it is entirely possible under the present law for a resident of the United States, whose property is largely situated in England, or some other foreign country, to be subject to both the United States estate tax upon all of his estate and the British or other foreign estate tax upon most of his estate. In view of the sharply increased rates of taxation, the combined tax in some cases would exceed the entire value of the estate, and the heirs would receive nothing.

The following table illustrates the estate taxes that would be payable under existing law by the estate of a resident of the United States, where a part of the assets of the estate were situated in a foreign country. The estate-tax rates now in force in Great Britain are used in computing the foreign tax. It should be noted that a citizen of a foreign country resident in the United States may be subject to the foreign tax on his entire estate, wherever situated, if the foreign law so provides. However, in the following table it is assumed that the foreign tax is imposed only on those assets situated in the foreign country:

Double taxation of estates of United States residents

[Figures in thousands of dollars]

Line No.	Net estate	Approximate United States tax [1]	Part of estate in foreign country		United States estate remaining after United States taxes	Approximate foreign tax [2]	Total estate tax		Total estate remaining after all taxes	
	Dollars	*Dollars*	*Dollars*	*Percent*	*Dollars*	*Dollars*	*Dollars*	*Percent*	*Dollars*	*Percent*
1	250	54	100	40	96	11	65	26	185	74
2	250	54	150	60	46	22	76	31	174	69
3	250	54	200	80	—[3] 4	34	88	35	162	65
4	500	133	200	40	167	34	167	33	333	67
5	500	133	300	60	67	66	199	40	301	60
6	500	133	400	80	—[3] 33	100	233	47	267	53
7	1,000	311	400	40	289	100	411	41	589	59
8	1,000	311	600	60	89	172	483	48	517	52
9	1,000	311	800	80	—[3] 111	250	561	56	439	44
10	5,000	2,443	2,000	40	557	832	3,275	66	1,725	34
11	5,000	2,443	3,000	60	—[3] 443	1,404	3,847	77	1,153	23
12	5,000	2,443	4,000	80	—[3] 1,443	2,000	4,443	89	557	11
13	10,000	6,058	4,000	40	—[3] 58	2,000	8,058	81	1,942	19
14	10,000	6,058	6,000	60	—[3] 2,058	3,276	9,334	93	666	7
15	10,000	6,058	8,000	80	—[3] 4,058	4,680	10,738	[4] 100	0	0

[1] Computed without credit for State taxes.
[2] Excluding legacy and succession duties ranging from 1 to 10 percent of legacy or bequest.
[3] Deficit.

The above table indicates that there is substantial double taxation which may leave the heirs of a large estate with nothing but a deficit. But, worse still, in the case of smaller estates, where the assets are principally located in a foreign country, the United States assets are insufficient even to pay the United States estate tax. (See lines 3, 6, 9, 11, 12, 13, 14, and 15 of the above table.)

While this situation, in a less extreme form, has existed for a number of years, it is at present greatly aggravated for several reasons:

1. A large number of European refugees have immigrated to the United States and have become residents.

2. The bulk of the property of such aliens has been left behind in foreign countries from which it cannot be removed because of freezing orders, exchange restrictions, or other prohibitions. Thus, while in the past an alien taking up his residence in the United States might avoid double taxation by bringing the bulk of his assets into the United States or converting his foreign assets into United States assets, this is no longer possible. For example, the proceeds of the sale of British assets cannot be applied to the purchase of United States assets.

3. Furthermore, should such aliens die and the tax become payable, it is impossible to convert such assets into United States dollars with which to pay the United States estate tax, because of freezing orders and exchange restrictions. In many instances, as appears from the above table, the assets in the United States are far from sufficient to pay the United States estate tax.

II. SUGGESTIONS FOR RELIEF

Accordingly, it would seem equitable that provisions for appropriate relief in these cases should be enacted. The following possible means for relieving this difficulty, at least partially, are suggested:

1. Residents of this country should be given a credit against Federal estate taxes for estate and inheritance taxes paid to foreign countries with respect to assets located in such countries. Such tax credit should not, however, exceed the United States estate tax which would be payable with respect to such assets.

2. Apart from the double taxation features of this problem which could be largely cured as suggested in paragraph 1 above, there is, because of the war and present exchange restrictions and controls, the additional problem of providing United States dollars for the payment of taxes with respect to assets located abroad. As a practical matter, foreign assets cannot be converted into dollars, so that in many cases it would be impossible to pay United States taxes in dollars. In many instances, the United States estate tax would completely exhaust the assets in the United States, leaving nothing for the heirs. This situation may well continue for years. Accordingly, it is suggested that a temporary United States estate tax be computed upon assets within the United States and assets convertible into United States dollars, but excluding property outside the United States not so convertible. The assets upon which this temporary tax had been paid would be distributable by the executors. The tax with respect to the non-convertible foreign property would become due and payable only after it became possible to convert such property into United States dollars. Such a provision, used in conjunction with the power now granted to the Commissioner by section 822 of the Internal Revenue Code to extend the time for payment of any part of the tax not to exceed 10 years from the due date, should furnish appropriate relief.

There is attached hereto, as appendix A, a draft of proposed legislation to cover the inequities discussed in this memorandum.

APPENDIX A

The following should be inserted in the revenue bill of 1942, as passed by the House of Representatives on July 20, 1942, to follow section 414 of such bill:

"SEC. 415. DELAYED TAXATION OF FOREIGN PROPERTY AND CREDIT FOR DEATH DUTIES PAID TO FOREIGN COUNTRIES. (a) The Internal Revenue Code is amended by inserting after section 813 the following new sections:

"'SEC. 814. DELAYED TAXATION OF FOREIGN PROPERTY. (a) As used in this section and in section 815, the term "foreign property" shall mean property subject to the jurisdiction and control of a foreign country because such property or the evidences of ownership thereof are located outside the United States.

"'(b) Where any property included in the gross estate of a decedent, citizen, or resident of the United States, is foreign property at the time of his death, and cannot because of freezing orders, exchange restrictions, or other prohibitions be converted into United States dollars, a temporary tax under sections 810 and 935 shall be computed upon the value of the net estate of the decedent determined without the inclusion of such foreign property in the gross estate, if the executor so elects upon his return (if filed within the time prescribed by law or prescribed by the Commissioner in pursuance of law). Where the return has already been filed at the date of enactment of this section, the election may be made in an amended return filed within six months of such date. No liabilities or claims connected with any property excluded from the gross estate for the computation of the temporary tax shall be deducted in determining the value of the net estate subject to the temporary tax. The temporary tax shall be due and

payable fifteen months after the decedent's death. If (a) at least one of the executors of the decedent is a bank or trust company incorporated under the laws of the United States, a State or Territory thereof, or the District of Columbia, and a majority of such executors are such banks or trust companies and/or individuals, citizens, and residents of the United States, and (b) all the executors file with the Commissioner a certificate whereby they undertake jointly and severally (1) to make diligent efforts to reduce all foreign property to their possession and control as soon as possible and (2) not to resign without the consent of the Commissioner, payment of such temporary tax shall release the property included in the gross estate for the purpose of computing such temporary tax, from the lien provided in section 827, the Commissioner shall issue his certificate releasing such property from such lien, and such property may be distributed by the executors without personal liability under section 3467 of the Revised Statutes or otherwise.

"'(c) Any property temporarily excluded from the gross estate of the decedent by subsection (b) for the computation of the temporary tax, shall be included in the gross estate for the computation of tax under sections 810 and 935 at such time or times as the Commissioner shall determine that such property can be converted into United States dollars, and the tax due by reason of such inclusion shall be due and payable within six months after such determination.

"'SEC. 815. CREDIT FOR ESTATE, SUCCESSION, LEGACY, AND INHERITANCE TAXES PAID TO FOREIGN COUNTRIES. The aggregate tax imposed by sections 810 and 935 shall be credited with the amount of any estate, inheritance, legacy or succession taxes actually paid to any foreign country in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent). The credit allowed by this section shall not (a) reduce the aggregate tax imposed by sections 810 and 935 below the amount which would have been payable under such sections upon the net estate, if the foreign property with respect to which the foreign estate, inheritance, legacy or succession taxes were paid, had been excluded in computing the net estate, or (b) be applicable against the temporary tax computed under section 814 (b) to the extent that such temporary tax is imposed with respect to the transfer of property other than foreign property. The credit allowed by this section shall include only such taxes as were actually paid and credit therefor claimed within six years after the filing of the executor's return, except that—

"'(1) If a petition for redetermination of a deficiency has been filed with the Board of Tax Appeals within the time prescribed in section 871, then within such six-year period or before the expiration of 60 days after the decision of the Board becomes final.

"'(2) If, under section 822 (a) (2) or section 871 (b), an extension of time has been granted for payment of the tax shown on the return, or of a deficiency, then within such six-year period or before the date of the expiration of the period of the extension.

"'(3) If the Commissioner shall determine under section 814 (c) that property of the estate can be converted into United States dollars, then within such six-year period or within two years after such determination.'

"(b) Section 822 (a) (1) of the Internal Revenue Code (relating to the time of payment of estate tax) is amended by striking out 'The' and inserting in lieu thereof 'except as provided in section 814 (c), the'.

"(c) Section 935 of the Internal Revenue Code is amended by adding new subsections (d) and (e), to read as follows:

"'(d) CROSS REFERENCE.—For provision with respect to delayed taxation of foreign property, see section 814.

"'(e) CROSS REFERENCE.—For provision with respect to credit for estate, succession, legacy, and inheritance taxes paid to foreign countries, see section 815.'

"(d) ESTATES WITH RESPECT TO WHICH AMENDMENTS APPLICABLE.—The amendments made by this section shall be applicable to estates of decedents dying on or after April 10, 1940."

Respectfully submitted.

ELISHA M. FRIEDMAN.

The CHAIRMAN. There are some letters here.

Senator Taft, I direct your attention to a letter from Mr. Charles Sawyer. You have talked with him.

Senator TAFT. Yes.

The CHAIRMAN. With reference to the amendments that were made in section 501 (b). It is not that the amendment is objected to by Mr. Sawyer, but he points out that a retroactive feature of the amendment strips two Ohio companies of their base credit.

Senator TAFT. Yes.

The CHAIRMAN. And he asks that the retroactive feature be made optional with the companies.

Senator TAFT. Yes. It seems to be a very clear case, I think.

The CHAIRMAN. We will put this letter in the record, but I would like to call the Treasury's attention to it specifically.

(The letter referred to is as follows:)

CINCINNATI, OHIO,
August 6, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: May I bring to your attention and ask you to insert in the record of the proceedings of the Committee on Finance the following matter. H. R. 7378, section 182, provides for the amendment of section 501 (b) dealing with exceptions to the definition of a personal holding company. Subsection (B) of section 7 provides that it shall take effect after December 31, 1938, which in effect makes it retroactive for 3 years.

Section 7 was designed to give relief to certain personal finance companies which were not organized nor availed of for the purpose of evading surtaxes upon the individual shareholders, but which might technically fall within the definition of a personal holding company. The object sought to be accomplished by this amendment is sound and in line with fair practice; but the retroactive feature of this amendment will cause great hardship to certain companies which undertook to comply with the law with reference to personal holding companies and by reason of that fact distributed practically all of their earnings to avoid the penalties which would otherwise be imposed.

If this retroactive feature should remain unchanged, these companies will find themselves in this position: In an effort to comply with the technical provisions of the personal holding company law they have disbursed large sums of money which would otherwise have remained in the companies to shareholders who have in turn paid large surtaxes upon these disbursements; from the depleted assets of these companies they must now disburse very large sums of money to pay excess-profits taxes which have heretofore not been payable. In other words, these companies have been forced to pay one tax on the theory that they are personal holding companies and will be forced to pay another tax on the theory that they are not.

I am sure that the inequity of this result will appeal to your committee immediately upon having it brought to its attention. I might cite as an example two Ohio companies—the City Loan & Savings Co., of Wapakoneta, Ohio, and the City Loan & Guaranty Co., of Lima, Ohio. Each of these companies is a large financial institution which has been in existence and doing business in Ohio for more than 25 years. Neither of them was organized as a personal holding company nor availed of for the purpose of avoiding surtaxes to individuals. However, as it appeared that the technical definition of personal holding company probably included these companies, they proceeded to file personal holding company returns and disbursed within the last 3 years very large amounts. To meet the double burden which would be imposed by this retroactive feature would present very serious problems to them.

The method suggested by which this dilemma may be met is to make the retroactive feature elective. In other words, the company may for the 3 years past classify itself as a personal holding company of not, assuming whatever burdens are imposed upon the decision which is made. For the current year and thereafter, the law as set forth in subsection 7, will fix the status of the particular company.

Respectfully yours,

CHARLES SAWYER.

The CHAIRMAN. The Association of Life Insurance Presidents have a wire here that it is desired to be put in the record.

(The telegram referred to is as follows:)

[Telegram]

AUGUST 3, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

In behalf of life-insurance policyholders, we urge upon your committee the restoration of the $40,000 specific exemption of life-insurance-policy proceeds in the estate-tax provisions of the revenue bill of 1942. The continuance of this exemption in the estate tax since 1918 is evidence of the Government's belief that it is socially desirable to encourage the maintenance of life insurance. This exemption has become deeply rooted in the American philosophy of taxation. Since life insurance constitutes the sole means through which persons of moderate income can immediately provide that their dependents will not become public charges after death, this exemption is of utmost importance.

We also urge your consideration of the proposal that provision be made in the income-tax sections for some reasonable deduction or credit for life-insurance premiums paid by policyholders for life insurance to protect their families. The greatly increased income-tax rates present a serious problem to many policyholders who have depended upon life insurance as the principal means of protecting their families against want and who must pay premiums out of current income. The continuance of premium payments on existing insurance is highly desirable from the standpoint of the Federal, State, and local governments.

THE ASSOCIATION OF LIFE INSURANCE PRESIDENTS.

The CHAIRMAN. The National League of Women Voters, through Miss Marguerite M. Wells, the president, has asked that this letter be inserted in the record. Without objection, that may be done.

(The letter referred to is as follows:)

NATIONAL LEAGUE OF WOMEN VOTERS,
Washington, D. C., August 7, 1942.

To: The Senate Finance Committee.
From: The National League of Women Voters.
Re: 1942 taxes.

The League of Women Voters at its 1942 convention went on record in favor of a war-finance program based to the largest possible extent on taxation that would check inflation and that would distribute equitably the burden of paying for the war. The league not only recognizes that it is desirable to meet as much of the cost of the war as possible through taxes in order to lighten the burden of post-war debt, but that taxation is one very important weapon in the battle against inflation. Taxes cannot do the whole job, but neither can price ceilings, rationing, or other devices do the job unless supported by a courageous and forthright tax program.

The tax bill should make a bigger dent on mass purchasing power.—The Treasury program is a good point of departure, and only that. It fails to recognize the fact that we cannot check inflation and redistribute national income at the same time. The basic facts continue to be: Increased war production means less production for civilians; fewer goods mean that standards of living for all persons will go down.

The choices are not pleasant ones. We can spare from taxes the low-income groups with mass purchasing power, but if we do we court inflation, which condemns those same groups to a worse fate. The easy choice is not to tax, but to ignore the threat of inflation; to continue to let people think that their increased money income means real income; and that we do not have to meet the costs of the war by sacrificing material benefits now.

Ways to reach mass purchasing power.—There are two ways of reaching mass purchasing power: Taxation based on total income or taxation based on expenditures for goods. The League of Women Voters is of the opinion that income taxation is basically better than most forms of sales taxation because a minimum

of income is left free from taxation and account is taken of the heavier responsibilities of families with children through the allowance for dependents. A sales tax, on the other hand, is likely to apply to almost the total income in families with little more than enough for necessities. Under a sales tax large enough to make an appreciable dent on excess purchasing power this would mean a heavier burden for the very poorest families than a really heavy income tax.

The income-tax proposals of the Treasury have been attacked as too severe. On the contrary, we should impose even heavier burdens, especially on the lowest income-tax brackets. This can be done by further reduction in exemptions, particularly the allowance for dependents, and by steeper rates, perhaps 30 percent or more on the first brackets of taxable income. If we do not have the courage to do this, a sales tax may be necessary, but under no circumstances should a sales tax be considered in lieu of any of the income-tax recommendations of the Treasury.

We recognize, of course, that the only way the income tax can be adapted to the needs of war finance is through some method of current collection. As families with smaller incomes are required to pay heavy taxes, the need for a system by which the tax can be paid as income is earned becomes imperative. Furthermore, such collection at source, is a vital part of the effort to check inflation, by withdrawing excess money from circulation before it an be spent.

MARGUERITE M. WELLS, *President.*

The CHAIRMAN. Also the letter from Mr. Charles Lachman, president of Charles Lachman Co., Inc., Phoenixville, Pa., who has filed a letter in lieu of personal appearance.

(The letter referred to is as follows:)

CHARLES LACHMAN CO., INC.,
Phoenixville, Pa., August 5, 1942.

Hon. WALTER F. GEORGE,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR: Rather than ask for valuable time to appear personally before your committee, this letter is being submitted as an informal brief in connection with the revenue bill now under consideration.

We are one of those small concerns ($150,000) which have been much discussed in Washington for a decade, but which have survived only in spite of legislation has not shaken the position of the large companies but has added burden upon burden to concerns like ourselves.

In 1926 we began what promised to be a long and successful business experience. Until October 1929 we enjoyed fair sailing. Through the 10 years of depression substantial progress was not possible. A ray of hope appeared about the middle of 1936, but this ended abruptly in the middle of 1937, when the decline both in volume and prices was more precipitous than in 1929, although not as deep. In 1938 a forced removal of our plant necessitated a 10-year loan of $65,000 from R. F. C.

Over all, we made little money but we stayed in the fight, confident that with the return of anything resembling normal conditions prosperity would be certain.

Now we are laboring under onerous conditions brought about by the war. If we make even modest profits it is the result of utmost endeavor; and if we do what benefit is there? The Government labors long to devise means to take away so much as to make diminution of working capital an absolute certainty.

It is not only for the war period that this threatens, but for long years thereafter, so that there is no hope for young business, especially one that has a debt to be paid. It is simply impossible to pay the heavy taxes, make necessary debt reductions, maintain plant, sustain high wage rates, and maintain working capital all at the same time. This is a matter of elementary arithmetic.

The House tax bill holds a death sentence. We plead for the right to live.

In its larger phase, what looms ahead is the end of America as a land of opportunity. Upon the Finance Committee rests the decision as to whether we shall have a heroic and dynamic free economy, or whether we shall be dumb driven cattle under a collectivism scheme of whatever name.

Respectfully,

CHARLES LACHMAN CO., INC.,
CHARLES LACHMAN,
President.

The CHAIRMAN. A letter is also filed on section 104, the Personal Holding Company Surtax Statute, by Mr. Norman B. Frost which, without objection, may be inserted in the record.

(The letter referred to is as follows:)

FROST, MYERS & TOWERS,
Washington, D. C., August 6, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR: I am writing you at the instance of Mr. Scott B. Appleby, who is very considerably interested in the subject matter of this letter.

In the Revenue Act of 1934 Congress passed what was known as the Personal Holding Company Surtax Statute—a law designed to supplement section 104 of the previous act and to prevent the accumulation of untaxed surpluses through the medium of incorporated pocketbooks.

Although at the time this act was passed various Government officials in high positions made public statements to the effect that corporations actively employing their capital in business need not be alarmed as no attempt would be made to tax them under this law, and despite the fact that two members of the House Committee on Ways and Means (Messrs. Celler and Disney, Congressional Record, June 19, 1939, p. 10503) subsequently declared on the floor of the House that the measure was never intended to include personal finance corporations, the Commissioner of Internal Revenue levied deficiency assessments against many personal finance and loan companies. The two circuit courts of appeal to which the question was carried (*Notoman v. Welch*, 108 F. (2d) 206; 2d Circuit, 1940; *Girard Investment Co.* v. *Commissioner*, 3d Circuit, decided Aug. 22, 1941), declared that while such companies were not within the intendment of Congress, nevertheless they came within the letter of the law and the courts could do nothing about the matter.

In enacting the Revenue Act of 1938, Congress sought to correct the situation by including an exemption for—

"A licensed personal finance company, under State supervision, at least 80 percent of the gross income of which is lawful interest received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed $300 in principal amount if such interest is not payable in advance or compounded and is computed only on unpaid balances."

This exemption covered a considerable percentage of the personal loan companies; but due to the fact that the personal loan industry is not well organized and that many companies belong to no group or association and hence were not represented before the tax committees, the 1938 amendment still permitted the Commissioner to tax many companies using in legitimate operations both capital and labor. Two companies might have been operating side by side in the same State, one taxable and the other not, with no real basis whatsoever for the differentiation. The only reason then and now suggested as a basis for discriminatory language, namely, that the exemption should be so framed as to avoid extending it to "loan sharks" is without foundation or merit, and was put forward to obtain group preference. Loan sharks are seldom incorporated, that form of doing business making them particularly vulnerable to law-enforcement activities.

As an instance of the injustice resulting from the narrowness of the 1938 amendment, the Seaboard Small Loan Corporation and Seaboard Security Co., companies controlled by Mr. Scott B. Appleby, licensed and operating in Georgia, were assessed and forced to pay for the years 1934 and subsequent years deficiency taxes and penalties which practically wiped out all of their earnings for the years in question. The reason they were not exempt under the 1938 amendment was that they discounted their loans and thus received interest in advance. Nevertheless, their rate of return was much less than that of companies operating in those years in States where the so-called 3-percent standard (Russell Sage) law was in effect.

It is proposed by section 182 of the House bill now pending before your committee to further exempt "certain corporations from personal holding company tax." The present amendment adds to the previous classification—

"(7) A loan or investment corporation subject to the supervision of State authority having supervision over financial institutions, a substantial part of

the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment, and making loans and discounts, and the loans to a person who is a shareholder in such corporation during such taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 503 (a) (2)) outstanding at any time during such year do not exceed $5,000 in principal amount."

Additional deficiency assessments and penalties have been levied against the Seaboard Security Co., Inc., of Atlanta, Ga., which would wipe out its earnings for 1938, 1939, 1940, and 1941, the total levies amounting to more than $100,000. This company would be exempt under the proposed House amendment but for the condition that an exempt corporation must be "subject to the supervision of State authority having supervision over financial institutions." The Seaboard Security Co., Inc., is licensed and operates under a building and loan statute of the State of Georgia (Georgia Building and Loan Association Laws, sec. 2878, et seq.), but I am advised by Georgia counsel that it is doubtful whether the corporation is "subject to the supervision of State authority having supervision over financial institutions." If there is any doubt whatsoever, the Commissioner of Internal Revenue will resolve it favorably to the Government, as perhaps he must do, and the corporation in question will be ruined. Its ruination will result not from any real distinction between it and the other loan companies that come within the exemption language of paragraph (7) of section 182 of the House bill or because its interest rate is higher, but from a mere technical difference between the status of that company under the laws, regulations, and procedure in Georgia, and the laws, regulations, and procedure in some other State.

If the amendment is passed in its present form, I have no doubt that next year some of the companies that are not included in this amendment will get together and bring pressure on Congress to remove the inequality that the proposed exemption will create by further broadening the exemption, thus adding confusion to the whole situation.

Under the circumstances, I respectfully but strongly urge that the words "subject to the supervision of State authority having supervision over financial institutions" be eliminated by your committee so that the question of a company's exemption will not depend on whether one State has or has not exercised supervision over such loan companies through its banking department. Such a distinction has nothing to do with the reason for passing the Personal Holding Company Act in the first place nor does it have any relationship to the situation which the 1938 and proposed 1942 amendment seeks to correct.

If any person or group still insists that loan sharks might receive benefit or comfort from the exemption thus changed, there might be substituted the words "operating under a State license and being subject to State authority;" though, conceivably, even that condition might bar a few legitimate, meritorious companies from the benefit of the exemption.

Believe me to be, Senator,

Respectfully yours,

NORMAN B. FROST.

The CHAIRMAN. Also a brief has been submitted by Mr. Harry L. Viser, certified public accountant, of Shreveport, La., who came here to appear but on account of a delayed schedule he arrived here after his place on the calendar had been passed, and he asked that this brief be incorporated in the record. I have read the brief. It is a very constructive brief. It is only 3 pages, and without objection that may be placed in the record.

(The brief referred to is as follows:)

BRIEF OF HARRY L. VISER, CERTIFIED PUBLIC ACCOUNTANT, SHREVEPORT, LA., ON SECTION 501, REVENUE BILL OF 1942

The undistributed-profits tax appeared for the first time in the Revenue Act of 1936. Its purpose was to force the payment of taxable dividends. Congress recognized that the bill would create harsh inequities in the case of debt-ridden corporations, and endeavored to afford relief to corporations in that category by

inserting section 26 in the bill. This section provided an additional credit, under circumstances where a written contract had been executed prior to May 1, 1936, providing for the application of earnings or profits in reduction of debt.

Since the enactment of the bill, Treasury officials have adopted a highly technical policy in applying section 26 to each individual case before it. Their position has been uniformly sustained by the courts. In consequence, the expressed congressional intent has been largely nullified.

To remove these injustices and restore the credits originally contemplated by the Congress, the Ways and Means Committee have inserted section 501 in the revenue bill of 1942, making this section retroactive in the effective date of the 1936 act.

This section affords direct relief to all corporations having a deficit as defined therein. It is doubted, however, that the section in its present terms will afford the full measure of relief desired to all classes of debt-ridden corporations, who have found themselves in the awkward position of being unable to distribute their net income because of prior commitments made for debt retirement.

This point can best be illustrated by a brief analysis of an actual case now pending before the Board of Tax Appeals. The salient points involved are as follows:

July 1, 1936, a corporation was organized to take over the assets and assume the liabilities of a group of predecessor corporations. Its organization was tax-free under the provisions of section 112 of the statute. Its opening balance sheet showed assets of $8,888,000; the liabilities it assumed amounted to $4,500,000, leaving a net equity of $4,388,000. Of the debt above assumed, more than $2,500,000 was secured by first mortgages upon the assets, together with an assignment of the income.

In filing its tax returns for the 2 succeeding fiscal years under the 1936 act, this corporation claimed the benefit of section 26 (c) (2), to the extent that the amount of debt reduction made out of income from the properties constituted contract credits. The Treasury adopted a contrary viewpoint, and held that because the statute uses the terminology "the corporation," the resulting credit would be denied. You see, the particular contracts under consideration were not executed by the taxpayer, but by its predecessors. In consequence of such a technical interpretation, the Treasury asserted a surtax on undistributed profits of $92,718.86 for the 2 years involved.

During the years in question this particular taxpayer reduced its indebtedness by payments from gross income far in excess of its undistributed net income. You see, the taxpayer was forced to apply the income from the properties on its debts under the terms of the mortgages it had assumed. It could not possibly distribute that income to its stockholders.

A precedent has since been established, upholding the Treasury's viewpoint, in the decision of the Board of Tax Appeals in the *Boeckeler Lumber Co. case* (43 B. T. A. 804).

The relief provisions of section 501 as enacted by the House are a step in the right direction, but it is feared that the section does not go far enough, because of the practical certainty that the Treasury will continue its present policy of narrow, technical interpretation which policy will continue the denial of relief to those debt-ridden corporations who are not so fortunate as to possess a deficit.

It is felt that an additional paragraph should be added to section 501, embodying the same terms and provisions that Congress wisely inserted in the Revenue Act of 1938. By inserting such provision in section 501 of the present bill, and changing the basic date from December 31, 1937, to May 1, 1936, the original intent of Congress to afford relief to debt-ridden corporations from the harsh provisions of the undistributed-profits tax will be accomplished. A suggested form of such amendment is as follows:

As used in this title with respect to any taxable year the term "dividends paid credit" means the sum of * * *.

"Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind, if such amounts are reasonable with respect to the size and terms of such indebtedness. As used in this paragraph the term "indebtedness" means only an indebtedness of the taxpayer existing at the close of business on April 30, 1936, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued and in existence at the close of business on April 30, 1936, or by a bill of exchange accepted prior to, and in existence at, the close of business on such date. Where the indebtedness is for a principal sum, with interest, no credit shall be allowed under this paragraph for amounts used or set aside to pay such interest."

The above concrete example has been given because this committee is constantly bombarded with theories, and therefore a factual presentation should prove diverting. There are a number of other cases pending before the Board of Tax Appeals and the courts, involving different phases of this somewhat technical question.

The taxpayers of the Southwest look to your committee for relief from the inequities created by harsh, narrow, technical interpretations of the revenue laws, at a time when they seem somehow to prevail before the courts of the Nation. It is their conception that the framers of the Constitution granted this prerogative to the Congress, to protect the weak and the lowly from injustices which might develop through the executive or judicial functions of our democratic form of government.

The CHAIRMAN. The committee will recess until 10 o'clock on Monday.

(Whereupon, at the hour of 1:50 p. m., a recess was taken until 10 a. m., Monday, August 10, 1942.)

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